JU11.7/2:1986-313

742-B

COMPLETED

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T. C. Memo. 1986-313

UNITED STATES TAX COURT

KENNETH H. MIYAMOTO AND CAROL SUE MIYAMOTO, ET AL., Petitioners[1]
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 3555-83, 3748-83, 3749-83, 3750-83.

Filed July 28, 1986.

Mark Arth, for the petitioners.

Mark A. Pridgeon and John C. Schmittdiel, for the respondent.

MEMORANDUM OPINION

FAY, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

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[1] Cases of the following petitioners are consolidated herewith: Robert W. Wagner and Marcella E. Wagner, docket No. 3748-83; Paul S. Gray and Jeanne R. Gray, docket No. 3749-83; and David S. Guckenberg and June E. Guckenberg, docket No. 3750-83.

ORIGINAL

C. M

Petitioners	Year	Deficiency
Kenneth H. Miyamoto and Carol Sue Miyamoto	1977 1978	$1,639.00 $1,096.00
Robert W. Wagner and Marcella E. Wagner	1978	$1,011.00
Paul S. Gray and Jeanne R. Gray	1977 1978	$2,198.00 $2,392.00
David S. Guckenberg and June E. Guckenberg	1977 1978	$ 325.00 $4,459.00

The issues are (1) whether petitioners are precluded by section 46(e)(3)[2], pertaining to noncorporate lessors, from claiming an investment tax credit with regard to components of certain leased restaurant facilities and, if they are not so precluded, (2) whether certain of these components constitute section 38 property and are thus eligible for the investment tax credit.

The facts have been fully stipulated. We set forth herein those facts pertinent to our decision.

Petitioners Kenneth H. Miyamoto and Carol Sue Miyamoto resided in Bloomington, Minn., when they filed their petition herein. They filed joint Federal income tax returns for 1977 and 1978, listing their respective occupations as "Food Service (General Manager)" and "Housewife".

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioners Robert W. Wagner and Marcella E. Wagner resided in Faribault, Minn., when they filed their petition herein. They filed a joint Federal income tax return for 1978, listing their respective occupations as "Self Employed" and "Housewife".

Petitioners Paul S. Gray and Jeanne R. Gray resided in Faribault, Minn., when they filed their petition herein. They filed joint Federal income tax returns for 1977 and 1978, listing their respective occupations as "Executive" and "Housewife".

Petitioners David S. Guckenberg and June E. Guckenberg resided in Tonka Bay, Minn., when they filed their petition herein. They filed joint Federal income tax returns for 1977 and 1978, listing their respective occupations as "Certified Public Accountant" and "Secretary/Housewife" on their 1977 return, and as "Corporate Officer" and "Housewife/Secretary" on their 1978 return.[3]

During or prior to the years in issue, petitioners Kenneth H. Miyamoto, (herein, "Miyamoto") Paul S. Gray (herein, "Gray"), David S. Guckenberg (herein, "Guckenberg") and Robert W. Wagner (herein, "Wagner"), together with certain other individuals, entered into a total of seven partnerships (herein referred to collectively as "the partnerships") as described herein. Gray, Guckenberg and Wagner entered into two partnerships during 1972, one entitled "Sandy's Investment Company of Fairmont" and the other "Sandy's Investment Company of Cloquet." Miyamoto, Gray, and Guckenberg entered into one partnership during 1976, entitled "Mason City Division, North Central Food Systems Investment Company" and another during 1977, entitled "Crookston Division, North Central Food Systems Investment Company." Miyamoto, Gray, Guckenberg and Wagner entered into two partnerships during 1975, one entitled "Grand Forks Division, Central Foods Systems Investment Company" and the other, "Superior Division, Central Foods Systems Investment Company". They also entered into one partnership during 1978, entitled "North Central Food Systems Investment Co., Hutchinson Division."

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[3] Both petitioners Paul S. Gray and Jeanne R. Gray and petitioners David S. Guckenberg and June E. Guckenberg filed amended returns for 1978. The propriety of the adjustments set forth in these amended returns is not in issue herein.

The partnership agreements for two of the partnerships, Sandy's Investment Company of Fairmont and Sandy's Investment Company of Cloquet, provided, in relevant part, as follows:

> The purpose of this Partnership is to acquire for investment, receive title to certain real estate located in * * * [a specified location], and to conduct the operation of leasing such real estate to others.

The partnership agreements for the five remaining partnerships provided, in relevant part, as follows:

> The purpose of this Partnership is to acquire for investment, receive title to certain real estate located in * * * [a specified location] and to conduct the operation of leasing such real estate to others, or to operate a retail fast food franchise thereon.

The partnership agreements do not indicate that any of the partnerships had as a business purpose the construction, manufacture or production of fast food franchise restaurant buildings or their components.

Each of the seven partnerships owns and leases a Hardee's fast food restaurant to North Central Food Systems, Inc.[4], a corporation which operates the restaurant under a franchise from Hardee's Food Systems Inc., of Rocky Mount, North Carolina (herein, "Hardee's Food Systems"). Hardee's Food Systems strives to achieve a uniform style and appearance with respect to the buildings housing the restaurants operated by its franchisees and, to this end, supplies detailed construction drawings and specifications for such buildings. These drawings and specifications were used in the construction of the seven restaurant buildings owned and leased by the partnerships.

The record contains copies of agreements pertaining to the construction of three of the seven restaurant buildings. The first of these is entitled "Construction Contract Agreement for the Construction of a Hardee's Family Restaurant." This agreement, which calls for the construction of a Hardee's restaurant at Crookston, Minnesota, is dated August 19, 1977, and is between "North Central Foods Systems, Inc., a corporation" as the owner,[5] and Bear Construction, Inc., of Grand Forks, North

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[4] A letter contained in one of the exhibits to the stipulation of facts indicates that petitioner David S. Guckenberg is president of North Central Food Systems, Inc. The record does not otherwise contain evidence concerning the relationship, if any, between North Central Food Systems, Inc., and the various partnerships or the individual partners.

[5] The parties have stipulated that all of the restaurant buildings are owned and leased by the partnerships to North Central Food Systems, Inc. However, the contract concerning the construction of the restaurant at Crookston, Minn., lists the (footnote continued)

Dakota as the contractor. Article II thereof provides, in relevant part, as follows:

> It is agreed by and between the parties: * * *
>
> (a) That the work included in this contract is to be done under the direction of the DIRECTOR OF CONSTRUCTION OF HCC CONSTRUCTION & EQUIPMENT CO. (hereinafter called "Director of Construction") and that his decision as to the true meaning of the contract documents shall be final;[6]
>
> (b) That for the purposes of the general conditions incorporated herein the Director of Construction shall be considered the Architect (the services of the Director of Construction shall be paid for by the OWNER);
>
> * * *
>
> (f) That neither Hardee's Food Systems, Inc., nor its subsidiaries shall have a voice in the selection, discharge, supervision or control of Contractor's servants, representatives, or sub contractors, or in fixing their number, compensation, or period of hours of service, nor shall it have any right to direct or instruct Contractor in the method of performance or the means of accomplishing the desired result except to the extent that a particular method is specified in this contract or in any specifications which are made a part hereof.
>
> (g) The contractor shall assign a job superintendent to this project when the work on this project is begun and the same job superintendent shall continue supervision of the work on this project until all work is completed or the contractor obtains written approval of changing job superintendent from HCC Construction and Equipment and the Director of Construction or original job superintendent is fired for good cause.

(footnote continued from previous page)
owner thereof as "North Central Foods Systems Inc.", and that entity is a party to the contract. The reason for this discrepancy is not apparent from the record.

[6] The record does not show the relationship, if any, between HCC Construction and Equipment Co. and the partnerships or individual partners herein.

This agreement also contains provisions relating to the contract price, time for completion, events of default, and various covenants of the contractor.

Of the two remaining construction agreements in the record, the first is dated as of May 1, 1978, and is between "Sandy's Investment Co. of Cloquet" as the owner and Paul S. Gray Co., Inc. as the contractor.[7] It designates the project as "renovation and addition to" a Hardee's restaurant in Cloquet, Minn. The second is dated as of June 6, 1978, and is between "Hardees Investment Co., of Hutchinson"[8] as the owner and Paul S. Gray Co., Inc. as the contractor. It designates the project as a new Hardee's Restaurant in Hutchinson, Minn. Each of these two contracts is entitled "Standard Form of Agreement Between Owner and Contractor" and is a standard form contract produced by the American Institute of Architects (AIA Document A101). Each is a four page document containing brief provisions relating to, among other things, the work, time of commencement, the contract sum, progress payments, and final payment.[9] Such agreements do not contain any provision concerning the owner's rights of control, if any, over the construction process.

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[7] Petitioner Paul S. Gray is president of Paul S. Gray Co., Inc.

[8] We assume that this entity is the same as "North Central Foods Systems Investment Co., Hutchinson Division", the partnership entered into by Miyamoto, Gray, Guckenberg and Wagner in 1978, but the record is not explicit on this point.

Each of the Hardee's restaurant buildings leased by the partnerships to North Central Foods Systems, Inc., contains various components. The parties agree that one of the restaurant buildings, located at Hutchinson, Minn. (herein, the "Hutchinson restaurant"), is representative of the others, and they have submitted detailed information pertaining thereto. The following table shows the various components of the Hutchinson restaurant, and their related costs.

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[9] Although the terms of certain other documents (e.g. "General Conditions AIA Document A201") appear to be incorporated by reference into these agreements, such other documents have not been made part of the record herein.

Description of Property	Cost Claimed
Parking Area Lighting	1,829
Decorative Divide Walls	587
Menu Board and Framing and Electric	749
Drive Up Window	526
Safe Installation	74
Lay in Acoustical Ceiling	3,559
Identity Soffit and Mansard	6,479
Sanitary Finishes	8,913
Cabinets and Counters	2,595
Toilet Room Accessories/Partitions	1,629
Kitchen Plumbing System	4,465
Drink Tubing Sleeves	848
Kitchen Exhaust Fans	1,652
Kitchen Make-Up Air System	4,306
Decorative Light Fixtures	1,154
Accent Light Fixtures	2,782
Battery Pack Lights	419
Kitchen Equipment Electrical	5,850
Cash Register Electrical	158
Sign Electrical	2,467
Signage	2,675
Total	53,716[10]

On their Federal income tax returns for the years in issue, petitioners claimed an investment tax credit based upon the costs relating to the foregoing components of the Hutchinson restaurant, as well as similar components of the six other restaurant buildings owned by the partnerships and leased to North Central Foods Systems, Inc. By statutory notices of deficiency issued on November 23, 1982, respondent determined that petitioners were precluded from claiming the credit by reason of the provisions of section 46(e)(3), pertaining to noncorporate lessors. Alternatively, respondent determined that petitioners had failed to provide a cost allocation of any property qualifying for the credit, and further, that the items of property for which the credit had been claimed consisted of structural components of a building and, as such, were ineligible for the investment tax credit.

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[10] By means of a supplemental stipulation of facts filed after submission of this case, the parties set forth similar cost information pertaining to the components of the restaurant buildings at locations other than Hutchinson, Minn.

In the instant proceedings, respondent concedes that some of the components of the restaurants are section 38 property and, as such, are eligible for the credit. However, he adheres to his position that petitioners are precluded from claiming any credit whatsoever by reason of section 46(e)(3). Thus, we must first determine whether petitioners are precluded by that section from claiming the investment tax credit with respect to components of the restaurants leased by the partnerships to North Central Foods Systems, Inc. If we determine that petitioners are not so precluded, we must determine whether the various components of the restaurants consist, to an extent greater than that conceded by respondent, of section 38 property eligible for the investment tax credit.

Under section 38, there is allowed a credit against tax with respect to a taxpayer's investment in certain qualifying property, known as section 38 property. However, section 46(e)(3) restricts the availability of the credit in the case of noncorporate lessors of property. It provides, in relevant part, as follows:

> SEC. 46(e)(3). NONCORPORATE LESSORS.-- A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if-
>
> (A) the property subject to the lease has been manufactured or produced by the lessor, or
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

* * *

Petitioners are seeking an investment tax credit with respect to property leased by the partnerships (i.e., noncorporate entities) of which they were partners. Thus, under the provisions of section 46(e)(3), petitioners may claim the credit only if the requirements of either section 46(e)(3)(A) or section 46(e)(3)(B) are satisfied. Petitioners contend that they have satisfied the requirements of section 46(e)(3)(A), under which the credit will be allowed if "the property subject to the lease has been manufactured or produced by the lessor."[11] Therefore, we must determine whether the leased property was manufactured or produced by the partnerships within the meaning of section 46(e)(3)(A).

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[11] Petitioners do not assert that the tests set forth in sec. 46(e)(3)(B) are satisfied.

Section 46(e)(3)(A) was first construed by this Court in Carlson v. Commissioner, 79 T.C. 215 (1982), affd. 712 F.2d 1314 (9th Cir. 1983). Therein, the taxpayer sought an investment tax credit with respect to certain apple-picking bins leased by him to a third party. The issue was whether the taxpayer had manufactured or produced the bins within the meaning of section 46(e)(3)(A). In resolving this issue, the Court looked to the legislative purpose behind the statute, and found that, in enacting section 46(e)(3),[12] Congress intended to deny the investment tax credit to noncorporate lessors who have merely retained passive investment or financing risks, as opposed to having assumed the risks and obligations usually associated with an active business. Carlson v. Commissioner, supra at 221, citing Ridder v. Commissioner, 76 T.C. 867, 872 (1981). We observed that, consistent with this legislative intent, section 1.46-4(d)(1)(i), Income Tax Regs., provides that a credit is allowed under section 38 to a noncorporate lessor of property if "such property has been manufactured or produced by the lessor in the ordinary course of his business." Construing the language of the statute and regulations in light of Congress' legislative purpose, the Court held that property is not transformed into "property manufactured by the lessor" simply because the lessor pays the costs and expenses associated with manufacturing it.

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[12] The relevant section was enacted by Congress as part of Pub. L. 92-178, 85 Stat. 497, and was originally designated as sec. 46(d)(3). It was redesignated as sec. 46(e)(3) by Pub. L. 94-12, 89 Stat. 26, effective for taxable years ending after December 31, 1974.

Rather, in order for the provisions of section 46(e)(3)(A) to be satisfied, the lessor must be involved with the manufacturing or production process by being either the one who actually manufactured or produced the property in issue, or the one who at least controlled the details of manufacture or production. Carlson v. Commissioner, supra at 222-223.

In Carlson, the apple-picking bins leased by the taxpayer had been ordered in a partly assembled condition by the lessee from a third party and delivered to the lessee's place of business. Assembly of the bins was completed by workmen selected by the lessee's general manager. These workmen, who received no instructions from the taxpayer, finished the assembly of the property on the lessee's premises and were paid directly by the lessee which, in turn, was reimbursed by the taxpayer. There was no evidence that the taxpayer was present at any time to supervise the workmen in assembling the bins or that he even inspected the bins to determine whether they were properly assembled. In light of these facts, the Court concluded that the apple-picking bins had not been manufactured or produced by the taxpayer within the meaning of section 46(e)(3)(A) since the taxpayer had not shown sufficient involvement in the assembly thereof. Accordingly, the taxpayer was held to be precluded from claiming the investment tax credit for the bins by section 46(e)(3).

More recently, section 46(e)(3)(A) was again interpreted by this Court in Egizii v. Commissioner, 86 T.C. 450 (1986). Therein, the taxpayers sought an investment tax credit with respect to certain components of a warehouse owned by them and leased to their wholly owned corporation, which operated a beverage distributorship. Respondent conceded that the warehouse components for which the taxpayers had claimed the investment tax credit were section 38 property, but argued that the taxpayers were precluded from claiming the credit for such property by reason of section 46(e)(3). The taxpayers contended, however, that they had satisfied the requirements of section 46(e)(3)(A).

In deciding whether the taxpayers were entitled to the credit with respect to the warehouse components, the Court first noted that the property leased by the taxpayers included both section 38 property (the specific components) and nonsection 38 property (the warehouse building itself). It was therefore necessary to consider the scope of section 46(e)(3)(A) and to determine precisely which property was required thereunder to have been "manufactured or produced by the lessor." The Court concluded that, for purposes of section 46(e)(3)(A), the property which must be "manufactured or produced by the lessor" is that property which is claimed to be section 38 property and for which the investment tax credit is sought by the taxpayer. Accordingly, the relevant inquiry was found to be whether the taxpayers had manufactured or produced those components of the warehouse which consisted of section 38 property, and not whether they had constructed the warehouse building itself. In resolving this inquiry, the Court applied the principles set forth in Carlson v. Commissioner, supra. It found that the taxpayers had entered into a contract for the construction of the warehouse facility. They had weekly contacts with the contractor's supervisory personnel concerning the status of construction, attended weekly on-site inspections, and consulted from time to time with the architect to ascertain that construction was being completed pursuant to the contract specifications. However, they were not involved in the actual construction of the warehouse or its component parts, nor were they present from day to day at the construction site. Moreover, the taxpayers had not shown that they furnished the specifications for the components, nor had they selected, instructed or supervised workers. Based upon these facts, the Court held that the taxpayers had not sufficiently controlled the manufacture of the components which were section 38 property so as to satisfy the provisions of section 46(e)(3)(A). Egizii v. Commissioner, supra at 455-458.

With the foregoing considerations in mind, we now consider whether petitioners have satisfied the requirements of section 46(e)(3)(A) and are thus entitled to an investment tax credit with respect to the components of the restaurants owned and leased by the partnerships.

Petitioners bear the burden of proving their entitlement to the claimed credit. See Uecker v. Commissioner, 81 T.C. 983, 998 (1983), affd. per curiam on another issue 766 F.2d 909 (5th Cir. 1985); Evans v. Commissioner, 48 T.C. 704, 709 (1967), affd. per curiam 413 F.2d 1047 (9th Cir. 1969); Rule 142(a). In order to show that the requirements of section 46(e)(3)(A) have been satisfied, petitioners must, under the rationale of Egizii v. Commissioner, supra, and Carlson v. Commissioner, supra, show that the partnerships manufactured or produced, or controlled the manufacture or production of, the specific components purporting to be section 38 property, and not merely that they constructed or controlled the construction of the restaurant buildings housing such property. The record, however, contains no evidence pertaining to the manufacture or production of the specific restaurant components claimed by petitioners to be section 38 property, or to the partnerships' control or lack of control with respect thereto. On such a record, we certainly cannot say that the partnerships manufactured or produced, or controlled the manufacture or production of, the components in question. Thus, we must conclude that petitioners have failed to carry their burden of proof in this regard.

Furthermore, to the extent that manufacture of the components of the restaurants may have been accomplished by means of the construction[13] of the restaurant buildings themselves, we find that petitioners have not established that the partnerships controlled the construction of such buildings in the ordinary course of their business within the meaning of section 46(e)(3)(A) and section 1.46-4(d)(1)(i) Income Tax Regs. The partnership agreements do not indicate that such entities intended to construct restaurant buildings in the ordinary course of their business. The restaurant buildings in question were constructed by independent contractors[14] pursuant to specifications furnished by Hardee's Food Systems, an unrelated corporation. None of the construction agreements in evidence specifies the right of the partnerships, if any, to control the construction process. Indeed, the most detailed of these agreements, which pertains to the construction of a restaurant at Crookston, Minn., and to which the relevant partnership is not even a party, appears to vest control over the construction process in the contractor and in the party designated as the Director of Construction, (HCC Construction and Equipment Co.), whose relationship to the partnerships, if any, is not reflected in the record. The record also fails to show that the partnerships in fact took an active role in the construction process. There is, for example, no evidence that the partnerships selected, instructed or supervised workers, maintained a regular presence at the construction sites, or otherwise were involved in the construction process to any meaningful extent. In short, the record fails to show that the partnerships controlled the construction of the restaurant buildings in the ordinary course of business. Cf. *Carlson v. Commissioner*, *supra*; *Egizii v. Commissioner*, *supra*; sec. 1.46-4(d)(1)(i), Income Tax Regs.[15]

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[13] In the context of sec. 46(e)(3)(A), the terms "manufacture" and "production" include the "construction" of property. See S. Rept. 92-437 (1971), 1972-1 C.B. 559, 583.

[14] The fact that property is constructed or manufactured by an independent contractor does not, of itself, require a conclusion that such property has not been constructed or manufactured by the taxpayer. See Carlson v. Commissioner, 79 T.C. 215, 224 (1982), affd. 712 F.2d 1314 (9th Cir. 1983). Under appropriate circumstances, wherein the taxpayer retains sufficient control over the construction process, the taxpayer may be considered to have constructed such property, even though the services of an independent contractor are used. Cf. Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063, 1069 (Fed. Cir. 1983); Illinois Power Co. v. Commissioner, 83 T.C. 842, 889-891 (1984), affd. on this issue 792 F.2d 683 (7th Cir. 1986).

Based upon the record herein, we find that petitioners have not shown that the partnerships controlled the manufacture or production of the restaurant components claimed by them to be section 38 property, and we thus conclude that petitioners have failed to carry their burden of proving that the provisions of section 46(e)(3)(A) have been satisfied.[16] We therefore hold that petitioners are precluded by section 46(e)(3) from claiming an investment tax credit with regard to the various restaurant components. In light of this holding, we need not determine the extent to which the various components of the restaurants in issue constitute section 38 property.

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[15] This case was submitted to the Court on the basis of a fully stipulated record, and we have therefore reached our conclusion herein based upon those facts set forth in the stipulation of facts, the supplemental stipulation of facts, and the exhibits thereto (herein, the "stipulations"). However, petitioners rely in their briefs upon certain factual allegations which were not referred to in the stipulations, but rather, which were contained in attachments to their petitions and which respondent expressly denied in his answers. These included, for example, the allegation that petitioner Gray, who was president of Paul S. Gray Co., Inc., supervised the construction of the restaurants on behalf of the partnerships. We accord no weight to such allegations, since, under Rule 143(b), unadmitted allegations in pleadings and statements made in briefs are not evidence and, in this fully stipulated case, we consider those matters not contained in the stipulations to be without support in the record.

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[16] In their briefs, petitioners rely upon Duaine v. Commissioner, T.C. Memo 1985-39. Although the taxpayer in Duaine had claimed an investment tax credit with respect to certain components of leased restaurant facilities, we consider that case to be inapposite to the instant case since the Court did not there have before it, as it does herein, the issue of whether the property in question had been manufactured or produced by the lessor under sec. 46(e)(3)(A).

Petitioners also cite Lykes Bros. Steamship Co. v. United States, 206 Ct. Cl. 354, 513 F.2d 1342 (1975); Pacific Far East Line, Inc. v. United States, 206 Ct. Cl. 378, 513 F.2d 1355 (1975); and Public Service Co. of New Mexico v. United States, 431 F.2d 980 (10th Cir. 1970). Although these cases involved the issue of whether, for purposes of the investment tax credit, the taxpayers had constructed, or instead, had acquired certain property, they did not arise in the context of sec. 46(e)(3)(A). See also Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063 (Fed. Cir. 1983); Illinois Power Co. v. Commissioner, 83 T.C. 842 (1984), affd. on this issue 792 F.2d 683 (7th Cir. 1986). Accordingly, such cases are less relevant herein than Carlson v. Commissioner, supra, and Egizii v. Commissioner, supra, both of which interpreted and applied section 46(e)(3)(A). Furthermore, in each of the cases cited by petitioners, the fundamental inquiry was, as here, whether the taxpayers had exercised control over the construction process. See Illinois Power Co. v. Commissioner, 83 T.C. at 889-890. We do not consider the principles set forth in these cases to be significantly different from those set forth in Carlson v. Commissioner, supra, which we have followed herein, and which itself relied upon Lykes Bros. Steamship Co. v. United States, supra, for analogous support in interpreting sec. 46(e)(3)(A). Carlson v. Commissioner, supra at 222. Accordingly, we do not read the cases cited by petitioners to require a result contrary to that reached by us herein.

To reflect the foregoing,

Decisions will be entered for respondent.

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COMPLETED

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T. C. Memo. 1986-314

MF 204

UNITED STATES TAX COURT

DONALD W. CROWELL AND SUZANNE C. CROWELL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2659-82. Filed July 28, 1986.

William R. Nicholas and Boyd J. Black, for the petitioners.

Charles W. Jeglikowski and David P. Fuller, for the respondent.

MEMORANDUM OPINION

CLAPP, Judge: Respondent determined a deficiency in petitioners' Federal income tax for the year 1973 in the amount of $28,268.19. The sole issue for decision is whether petitioners are entitled to a theft loss deduction under section 165(c)(3)[1] with respect to their investment in the stock of Equity Funding Corporation of America (EFCA).

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[1] All references to sections are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

G. M

This case was submitted fully stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Petitioners, Donald W. Crowell and Suzanne C. Crowell, husband and wife, resided in San Marino, California, at the time the petition was filed in this case.

Since at least 1970, petitioner, Donald Crowell (hereinafter petitioner in the singular) has been a stockbroker with and the managing partner of Crowell, Weedon & Co., a regional securities brokerage and investment firm. In 1970 and 1971, petitioner purchased shares of the outstanding common stock of EFCA on the open market as follows:

Trade Date	Settlement Date	Price Per Share	Number of Shares	Cost (including commissions and service charges)
10/9/70	10/19/70	$ 26.50	500	$ 13,411.25
10/9/70	10/19/70	26.125	500	13,237.80
10/16/70	10/23/70	24.625	300	7,496.43
10/19/70	10/26/70	24.375	200	4,952.38
11/10/71	11/17/71	33.50	500	16,943.75
		Totals	2,000	$ 56,041.61

EFCA was formed in 1961. Its principal product was the sale of life insurance coupled with shares of mutual funds. The package was marketed as a planned investment and insurance program which emphasized equity investments with growth potential while providing insurance protection. Participants utilized their mutual fund shares as collateral to finance their insurance premiums.

The insurance sold by EFCA was primarily written by Equity Funding Life Insurance Company (EF Life), an Illinois-chartered subsidiary of EFCA. EFCA owned several other subsidiaries involved in the sale of insurance. EFCA was a holding company with diverse interests in insurance, securities, banking, cattle, real estate development, oil and gas and foreign investments.

EFCA made its first public offering of stock in 1964. Its annual audited financial statements then and thereafter became a matter of public record in prospectuses, in registration statements and reports filed with the Securities and Exchange Commission (SEC) and in reports to shareholders. In its public certified financial statements, EFCA reported steady growth from 1964 through 1972 in gross income, net earnings, stockholders' equity and earnings per share.

Rumors regarding EFCA spread on Wall Street after March 6, 1973 and EFCA's stock became a volume leader on the New York Stock Exchange (NYSE). Its price declined steadily. On January 3, 1973, EFCA stock had traded at a 1973 high of $36.875 per share. On March 27, 1973, the NYSE, at 12:45 p.m. Eastern Standard Time, suspended trading in EFCA stock. The stock was then trading at $14.375. On March 28, 1973, the SEC ordered a suspension in trading of all EFCA securities on all exchanges.

On March 30, 1973, the California Department of Insurance seized EF Life. On April 2, 1973, the California Department of Insurance filed an application in the Superior Court of the State of California for the County of Los Angeles seeking to place EF

Life in conservatorship stating, among other grounds, that EF Life had been reporting to its reinsurers fictitious life insurance policies in violation of section 484 of the California Penal Code. The application was granted by the Superior Court.

On April 3, 1973, the SEC filed a complaint in the United States District Court for the Central District of California alleging violations of the Federal securities law by EFCA and its officers. Among other allegations, the SEC asserted that EFCA, acting by and through its officers and employees, had employed a scheme to defraud investors, engaged in acts and practices which operated as a fraud and deceit upon such investors, and had made untrue statements of material facts or omitted material facts in connection with the purchase and sale of EFCA's securities and those of some of its subsidiaries and affiliates. EFCA consented to the entry of a permanent injunction against it.

On April 5, 1973, EFCA filed a petition for protection under Chapter X of the Federal bankruptcy laws in the United States District Court for the Central District of California. With the disclosure of problems at EFCA and its subsequent petition for bankruptcy, beginning as early as April 6, 1973, major brokerage houses in the United States sent out margin calls to investors who held Equity Funding stock in margin accounts. On April 10, 1973, a trustee was appointed in the EFCA bankruptcy proceeding. On March 8, 1974, the trustee issued a report to EFCA's creditors and stockholders summarizing the fraudulent practices of EFCA. The trustee categorized the activities into three types:

"creation and inflation of assets in the balance sheet; failure to record liabilities for borrowed cash; and the creation of bogus insurance, most of which was coinsured with other insurance companies."

On October 31, 1974, the trustee filed a lengthy report in the EFCA bankruptcy case which detailed the history of the EFCA fraud. The trustee concluded that the fraud scheme was motivated by a desire on the part of the participants to inflate the market price of EFCA's stock. The originators of the conspiracy were also major holders of EFCA's stock. In the trustee's opinion, the fraud was principally carried out by inflating the company's reported earnings, largely by recording bogus income.

On November 1, 1973, a Federal grand jury in Los Angeles, California, handed down an indictment with 105 counts including securities fraud, mail fraud and filing false documents with the SEC, against the principal officers of EFCA. On November 30, 1973, one of the officers pled guilty under a plea bargaining arrangement. Indictments were also returned by Illinois and New Jersey grand juries. All of the principal officers either pleaded guilty or were found guilty of some of the charges.

On December 8, 1975, the Federal bankruptcy court approved the trustee's plan of reorganization for EFCA. As shareholders in EFCA, the Crowells were included in the class of EFCA creditors entitled "Creditors Class 8 -- Fraud Claimants." Pursuant to the trustee's plan of reorganization approved by the bankruptcy court, Orion Capital Corporation (Orion) succeeded to certain assets of EFCA. On October 12, 1976, Orion stock certificates were distributed to claimants in the EFCA bankruptcy proceeding. The Crowells received 561 shares of Orion. Trading in Orion stock was first quoted in the over-the-counter market on October 18, 1976 at $4.375 bid.

On their 1973 income tax return, petitioners claimed a casualty or theft loss of $55,942 ($56,042, basis in EFCA stock, minus $100). In his notice of deficiency dated November 30, 1981, respondent disallowed the loss.

Petitioners contend that the loss sustained in regard to their EFCA shares constituted a theft and therefore is deductible under section 165(c)(3).

This issue has already been resolved in respondent's favor in DeFusco v. Commissioner, T.C. Memo. 1979-230. In that case, relying on Barry v. Commissioner, T.C. Memo. 1978-215, we held that the taxpayer was not a victim of theft under California law with respect to his purchases of EFCA's stock on the open market. The fatal flaw in taxpayer's case was the lack of privity between the alleged defrauder and the taxpayer. Petitioners contend that DeFusco does not constitute an accurate statement of applicable California criminal law. Petitioners argue that under section 484 of the California Penal Code the perpetrator making the false representation need not personally receive the benefit of his fraud. However, this Court specifically stated:

> We also note that under California law it is unnecessary to prove that the defrauder benefitted personally from the fraudulent acquisition. People v. Ashley, 42 Cal. 2d 246 P.2d 271 (1954); People v.

> Jones, 36 Cal. 2d 373, 224 P.2d 353 (1950). But those cases also underscore that there must at least be an appropriation by the defrauder of the victim's property--an essential element of theft which is lacking in the instant case. [38 T.C.M. 920, 922; 48 P-H Memo T.C. par. 79,231 at 878-79.]

Although the alleged defrauder does not need to obtain the property for himself, an essential element of the crime of theft by false pretenses is the intent to defraud the owner of his property. People v. Fujita, 43 Cal. App. 3d 454, 117 Cal. Rptr. 757 (1974), cert. denied 421 U.S. 964 (1975). Implicit in this element and present in all of the cases decided by California courts relied on by petitioners is a relationship of privity between the perpetrator and his victim. Here, however, petitioner purchased the stock on the open market. There is no evidence that the officers of the corporation in making fraudulent misrepresentations did so with the specific intent of depriving petitioners of their money. See Paine v. Commissioner, 63 T.C. 736, 741-742 (1975), affd. without published opinion 523 F.2d 1053 (5th Cir. 1975).

Petitioners also argue that they suffered a theft loss under Federal criminal law. It is well settled, however, that the law of the State where the loss was sustained determines whether or not a theft has occurred. Paine v. Commissioner, supra at 740.

We can find no basis for distinguishing this case from DeFusco v. Commissioner. Accordingly, we hold that respondent's determination must be sustained.[2]

Decision will be entered for the respondent.

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[2] In the alternative, respondent argues that even if there were a qualified theft loss, it is not allowable in 1973 because a reasonable prospect of recovery existed in that year. The opinion in DeFusco is dispositive of this issue in respondent's favor as well.

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T. C. Memo. 1986-315 5

MI 204

UNITED STATES TAX COURT

FRED BOEHMER AND MARION BOEHMER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15958-84. Filed July 28, 1986.

Fred Boehmer, pro se.

Elise Frost Alair, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CLAPP, Judge: Respondent determined a deficiency for the year 1981 in the amount of $1,126.00. The sole issue for decision is whether petitioners are entitled to deduct automobile expenses incurred by Fred Boehmer, petitioner, while traveling daily from his home in Yorktown Heights, New York to his place of work in Danbury, Connecticut.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

ORIGINAL

C. M

Petitioners resided in Yorktown Heights, New York at the time the petition was filed.

Petitioner, Fred Boehmer (hereinafter referred to as petitioner in the singular), was an ironworker by trade, who had worked at numerous job sites over the past approximately 30 years. He was a member of the ironworkers union and looked to the Union Hall in New Haven, Connecticut for assignment to his various jobs. The following chart is a summary of petitioner's employment history during 1975 through 1984:

YEAR	EMPLOYER	JOB SITE	DATES
1984	Unable to work		
1983	Unable to work		
1982	Cupples	Danbury, Conn.	1/4/82-1/15/82
1981	Cupples/Robertson	Danbury, Conn.	1/5/81-12/31/81
1980	G-H Steel	Danbury, Conn.	1/2/80-9/4/80
	SPM Construction	Danbury, Conn.	One day in May
	H.H. Robertson	Danbury, Conn.	9/5/80-12/31/80
1979	G-H Steel	Danbury, Conn.	1/2/79-3/26/79
	G-H Steel	Danbury, Conn.	3/30/79-12/31/79
1978	M. Connors	Westbury, Conn.	1/2/78-4/28/78
	Hall Rebar	Danbury, Conn.	5/4/78-5/12/78
	R M Steel	Baldgerport, Conn.	6/15/78-6/29/78
	Monroe Reinforce	Newtown, Conn.	7/26/78-7/31/78
	G-H Steel	Danbury, Conn.	8/1/78-12/30/78
1977	J & L Concrete	New Milford, Conn.	1/3/77-3/30/77
	Out of Work		3/30/77-7/20/77
	MJC Rebar	West Port, Conn.	7/21/77-12/31/77
1976	Brownall Co.	Danbury, Conn.	7/13/76-11/2/76
	J-L Concrete	New Milford, Conn.	12/9/76-12/31/76
	Out of Work		1/2/76-7/12/76
1975	EPD Construction	Greenwich, Conn.	11/2/75-7/31/75
	Brunalli Construc.	Danbury, Conn.	11/24/75-11/26/75

All of these jobs were located within a radius of approximately 40 miles from petitioner's home. Danbury, Connecticut, where the petitioner worked during the entire year 1981, was approximately 25 miles from petitioner's home.

During the year at issue, petitioner drove daily from his home in Yorktown Heights, New York, to his job site in Danbury, Connecticut, and returned home every night.

Respondent determined in the notice of deficiency that these automobile expenses were nondeductible personal commuting expenses under section 262.[1]

OPINION

Clearly, the expenses in question do not fall under section 162(a)(2) because petitioner was not "away from home" overnight. See United States v. Correll, 389 U.S. 299 (1967). Therefore, respondent states that if the expenses are deductible at all they would be deductible under section 162(a) citing Boone v. United States, 482 F.2d, 417, 419 n.2 (5th Cir. 1973); Sanders v. Commissioner, 439 F.2d 296, 298 (9th Cir. 1971). Section 162(a) permits a deduction for all ordinary and necessary expenses incurred in carrying on any trade or business. As respondent points out, the costs of daily commuting between a taxpayer's home and his place of employment are considered nondeductible personal expenses under section 262. Respondent has made an exception to this rule when the taxpayer's expenses are incurred in travelling between taxpayer's residence and a temporary jobsite outside the taxpayer's normal area of employment. See McCallister v. Commissioner, 70 T.C. 505, 508 (1978); Norwood v. Commissioner, 66 T.C. 467, 469 (1976). Revenue Ruling 190, 1953-2 C.B. 303. We held that such commuting expenses, even to a temporary jobsite, were not deductible in Turner v. Commissioner, 56 T.C. 27 (1971), vacated and remanded on respondent's motion by unpublished order (2d Cir. March 21, 1972). Respondent once again has chosen not to rely on this case.[2] Instead, respondent states that his position is exemplified by Tamargo v. Commissioner, T.C. Memo. 1984-175 where the issue decided was whether the taxpayer's employment was temporary or indefinite.

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[1] All references to sections are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

Petitioner argues that the employment during the year in question was temporary. The only evidence petitioners presented to support their position is petitioner's prior work history. His jobs prior to the one at issue never lasted too long. Prior jobs of short duration, however, are not evidence that the job at issue is temporary. McCallister v. Commissioner, supra at 510.

We find it unnecessary to resolve the question of whether petitioner's employment was temporary or indefinite. We do not need to go as far as Turner v. Commissioner, supra, although we view that case with approval. Here, the distances between petitioner's personal residence and places of employment were minimal. Petitioner was employed since 1975 within 40 miles from his home and during the year at issue was 25 miles from his home. Petitioner admitted that his residence was centrally located to his places of employment. Commuting expenses incurred travelling to job sites within the general area of the taxpayer's residence are not deductible. *Ellwein v. United States*, 778 F.2d 506 (8th Cir. 1985).[3] Therefore, we conclude that the automobile expenses constitute personal commuting expenses and are not deductible pursuant to section 262.

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[2] Respondent originally adopted the position of Turner v. Commissioner, 56 T.C. 27 (1971) in Rev. Rul. 76-453, 1976-2 C.B. 86. Congress, in order to allow more time to consider the issues, passed legislation, P.L. 95-427, 92 Stat. 996 (1978), directing that the deductibility of transportation expenses was to be determined in accordance with the rules in effect prior to Rev. Rul. 76-453. After one extension, Pub.L. 96-167, 93 Stat. 1275 (1979), this legislation expired on May 31, 1981, part way through the year at issue.

Decision will be entered
for the respondent.

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[3] See also *Epperson v. Commissioner*, T.C. Memo. 1985-382.

JU11.7/2:1986-316

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T. C. Memo. 1986-316

MF204

UNITED STATES TAX COURT

HIROTOSHI YAMAMOTO AND SHIZUKO YAMAMOTO, Petitioners, v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 29006-81. Filed July 28, 1986.

Hirotoshi Yamamoto, pro se.

Henry E. O'Neill, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	Deficiency
1978	$77,684.88
1979	82,659.55

C.M.

ORIGINAL

The issues for decision are: (1) whether interest petitioners paid during 1978 and 1979 was "investment interest" as defined in section 163(d)[1]; (2) whether petitioners' transfer of property to a corporation qualifies for non-recognition treatment under section 351; and (3) whether the gain petitioners realized from the sale of two houses represents ordinary income.

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. Hirotoshi and Shizuko Yamamoto (petitioners) resided in Honolulu, Hawaii, when they filed their petition in this case. They filed joint Federal income tax returns for the years 1978 and 1979.

Hirotoshi Yamamoto, (hereinafter referred to individually as petitioner) owned stock in three corporations: Manoa Finance Company, Manoa Investment Company, and Manoa Enterprises, Inc.

Manoa Finance Company (MFC) was an industrial loan company incorporated under the laws of the State of Hawaii in 1961. Until 1977, petitioner owned all of MFC's common stock, and was one of several owners of MFC's non-voting preferred stock.

Industrial loan companies in Hawaii such as MFC make loans and issue interest-bearing thrift certificates to savers. The State of Hawaii closely regulates industrial loan companies, and in particular prohibits industrial loan companies from having outstanding at any time debentures or loan certificates in excess of 10 times the amount of paid up capital and surplus. Hawaii Rev. Stat. sec. 408-14 (1976).

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

The volume of MFC's business expanded during the period between 1961 and 1977, and therefore MFC needed constant increases in equity capital to maintain the debt to capital ratio required by the State of Hawaii. Petitioner purchased considerable amounts of common stock in MFC during this period in order to provide the company with the amount of equity required by State law. The following is a summary of the value of common stock held by petitioner during this period.

1961-62	$ 125,000
1963	229,500
1964	404,670
1965	656,170
1966	817,170
1967	1,216,550
1968	1,561,050
1969	1,614,050
1970	2,008,550
1971	2,305,300
1972-76	2,780,300
August/1977	2,830,300

In order to pay for the common stock he purchased during this period, and for preferred stock he purchased after the summer of 1977, petitioner incurred a substantial number of loans. In addition, he incurred loans whose proceeds were stipulated to have been put to "business uses," or used to purchase "other investment property," or "net lease property." The parties have agreed upon the proper amounts allocable to each of these uses, and it is only with respect to the tax consequences of loan proceeds used to purchase stock in MFC that the parties disagree.

MFC at various times loaned money to Manoa Investment Company (MIC), whose shares were held in their entirety by petitioner. MIC would, in turn, lend money to petitioner. As of December 31, 1975, petitioner owed $960,090.50 to MIC, resulting from advances made between February 8, 1965 and December 31, 1975. On at least one occasion, petitioner used proceeds of a loan from an unrelated finance company in order to repay a loan obtained from MIC. The proceeds of the MIC loan were originally used to purchase additional stock in MFC in order to satisfy the State requirement for minimum capital.

In 1983, the State of Hawaii put MFC into receivership for allegedly failing to satisfy the required debt to capital ratio.

On their 1978 and 1979 Federal income tax returns, petitioners claimed interest deductions in the amounts set forth below:

	1978	1979
Interest deducted on Schedule C as an expense of petitioner's proprietorship contracting business	$185,773.93[2]	$167,883
Petitioners' distributive share of interest deducted on Schedule E by joint venture of Takahashi and Yamamoto	90,420.00	72,412
Totals	$276,193.93	$240,295

After an audit of petitioners' 1978 and 1979 Federal income tax returns, the examining agent determined that the proceeds of many of the loans had been used to purchase stock in MFC, and that interest payments on those loans represented investment interest expense subject to the limitations of section 163(d).

The dates on which the loans were incurred are relevant to determining the extent of limitations imposed by section 163(d). Some of the loans originated prior to December 17, 1969, others originated after December 16, 1969 but before September 11, 1975, and a third group originated after September 10, 1975. Some of the loans were refinanced after September 10, 1975, and some of the loans were made in exchange for unsecured demand notes.

In 1977, petitioner organized Manoa Enterprises, Inc. (MEI) and became its sole shareholder. He then exchanged his shares of MFC common stock for $1 million worth of common stock in MEI, plus an account receivable in the amount of $1,830,300. The

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[2] The stipulation, apparently due to a typographical error, reports this figure at $185,733.93.

State of Hawaii objected to this transaction and ordered its reversal. Petitioner failed to take any action with respect to the State's objections.

In 1978, petitioners held non-voting preferred stock in MFC worth $715,000. Other shareholders' combined holdings of non-voting preferred stock amounted to $387,500. Petitioners thus held approximately 62 percent of the value of the non-voting preferred stock.

In 1978, petitioners transferred to MFC a rooming house which they had purchased in 1955. Petitioners' basis in the rooming house was $10,833.39. At the time, petitioners valued the property at $150,000. It was subject to liabilities in the amount of $111,493.52. MFC subsequently sold the property in 1978 for $180,000. On April 24, 1978, petitioners acquired 6,585 shares of non-voting preferred stock in MFC for $38,500. On April 25, 1978, petitioners received a check from MFC in the amount of $38,506.48, representing the difference between the $150,000 value of the rooming house and $111,493.52 of liabilities assumed. Petitioners claim that the transfer of the rooming house to MFC in exchange for stock qualifies for nonrecognition under section 351.

Petitioner was a general partner in Waianae Associates. In 1960, Waianae Associates purchased a 300-acre tract of land in Waianae, Hawaii, and subsequently sold 25-acre parcels to different developers.

Some of the developers borrowed money from MFC to develop the parcels. One developer was unable to complete the project. In order to facilitate construction and to insure payment to MFC, petitioner constructed seven homes on seven separate lots. Five of the homes were sold after construction was complete. Petitioner reported the gain from these sales as ordinary income.

Construction of the two unsold houses was completed in May of 1973. They were immediately listed with Manoa Realty, petitioners' proprietorship business, for sale through Multiple Listing Service. Due to a depressed real estate market at the time, however, the properties could not be sold for the price asked. In 1974, the property was listed for another year with Multiple Listing Service. The listing was not renewed in 1975.

In 1975, petitioner concluded that he would be unable to sell the houses while the real estate market remained depressed. He decided to rent the houses instead. During the period from 1975 through 1978, petitioner did not install a "For Sale" sign on the property, and he did not list the houses with a sales agency.

In 1978, a buyer approached him and ultimately purchased both houses for $127,000. Petitioners reported the gain as long-term capital gain.

OPINION

Issue 1. Claimed Deductions for Interest on Loans.

MFC needed additional equity in order to meet Hawaii's required equity to debt ratio. Petitioner incurred personal loans in order to increase MFC's capital account, and took back stock in exchange for the loan proceeds. He claimed deductions on his Federal income tax returns for the amounts he paid as interest on the loans.

Respondent contends that the interest constitutes "investment interest" and thus is subject to the limitations of section 163(d). Petitioner contends that the stock was not acquired with investment motives, but rather was acquired in order to help MFC to meet the requirements of State law, and hence for trade or business purposes.

Section 163(d) limits the deduction of "investment interest" to $10,000 plus certain additional amounts. The term "investment interest" is defined as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." Section 163(d)(3)(D). Legislative history makes it clear that interest on funds borrowed for use in connection with a trade or business is not affected. H. Rept. No. 91-413 (1969), 1969-3 C.B. 200, 246. Compare section 57(b)(2)(D) prior to amendment by the Tax Reform Act of 1976, Pub. L. 94-455, section 301(c)(2)(f), (g), 90 Stat. 1549.[3]

The issue, therefore, is whether petitioner acquired and retained additional stock in MFC for investment or business purposes. If the stock was held with sufficient investment intent to result in a capital gain or loss upon its disposition, then interest paid on a loan to acquire the stock is investment interest. See Miller v. Commissioner, 70 T.C. 448, 455, (1978).[4] As we stated in Miller v. Commissioner, supra at 455:

> In W. W. Windle Co. v. Commissioner, 65 T.C. 694, 714 n. 15 (1976) * * * this Court noted that "stock is normally a capital asset" owned for investment purposes, and held that only where the "original purpose of [the] acquisition and the reason for continued retention are both devoid of substantial investment intent should the stock be treated otherwise." * * * This test is also applicable here to determine whether the BNB stock was "held

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[3] Sec. 57 treated "excess investment interest" as an item of tax preference. Sec. 57(b)(2)(D) defined "investment interest expense" as follows:

> (D) INVESTMENT INTEREST EXPENSE.--The term "investment interest expense" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For purposes of the preceding sentence, interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as an investment interest expense.

[4] The issue in Miller v. Commissioner, 70 T.C. 448 (1978), was whether a loan incurred to purchase stock involved "investment interest expense" for purposes of former sec. 57(b)(2)(D), involving the minimum tax on items of tax preference. The similarities between former sec. 57(b)(2)(D) and the definition of investment interest in sec. 163(d)(3)(D) make our reasoning in Miller v. Commissioner, supra, applicable to the instant case. See Miller v. Commissioner, supra at 454-455 and n. 4.

> for investment." If the stock was held with sufficient investment intent to result in a capital gain upon its disposition, then the abuses resulting from the use of borrowed money to acquire capital assets, which Congress sought to prevent in enacting section 57, are present. Applying a different standard requiring a greater degree of investment intent * * * would frustrate congressional policy. The minimum tax would be inapplicable to a loan incurred to purchase property which, because of the owner's substantial investment intent, would produce capital gains upon disposition. [Fn. ref. omitted.]

Thus, only where both the original purpose of the acquisition and the reason for continued retention are "devoid of substantial investment intent" will the stock be considered to have been held for purposes other than investment. Miller v. Commissioner, supra; Continental Ill. Nat. Bank v. Commissioner, 69 T.C. 357 (1977); W. W. Windle Co. v. Commissioner, 65 T.C. 694, 714 n. 15 (1976). Whether petitioner acquired and retained the stock in MFC without substantial investment intent is essentially a factual question. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 51 (1955); Miller v. Commissioner, supra at 456.

The parties have stipulated that petitioner purchased stock in order to enable MFC to maintain the State-required level of capital. Petitioner argues that interest paid to purchase stock acquired as part of "an active, life or death struggle for the survival of the corporation" should not be construed as investment interest. Respondent replies that "[t]he corporation's business purpose for requiring funds does not transcend the corporate entity."

Petitioner is correct in stating that, in some circumstances, securities may be acquired for business purposes without substantial investment intent. E.g., Commissioner v. Bagley & Sewall, 221 F.2d 944 (2d Cir. 1955), affg. 20 T.C. 983 (1953); Enoch v. Commissioner, 57 T.C. 781 (1972). Thus, courts have held that a corporation in the business of manufacturing corn products acquired corn futures contracts as an integral part of its manufacturing business, Corn Products Refining Co. v. Commissioner, supra; that a corporation acquired bonds as means to secure contract delivery and without investment intent, Commissioner v. Bagley & Sewall, supra; and that bonds purchased to meet FHA loan reserve requirements were integrally related to the business of a corporation that owned an apartment complex, Enoch v. Commissioner, supra.

Respondent, however, is also correct in stating that the trade or business of a corporation is not necessarily the trade or business of its shareholder. As the Supreme Court has stated: "Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged." Whipple v. Commissioner, 373 U.S. 193, 202 (1963).

Beginning with this premise, courts have frequently denied to shareholders deductions related to expenditures they had made on behalf of their corporations. E.g., Perlman v. Commissioner, 27 T.C. 755 (1957), affd. 252 F.2d 890 (2d Cir. 1958); Eskimo Pie

Corporation v. Commissioner, 4 T.C. 669 (1945), affd. 153 F.2d 301 (3d Cir. 1946); Margolis v. United States, 570 F. Supp. 170 (N.D. Cal. 1983). We held in Perlman v. Commissioner, supra, that a shareholder's cancellation of his corporation's debt to him was not a business loss or expense, even though it was made necessary because the corporation's "capital and surplus account was far too low in relation to the amount of premiums written, and there was danger that the State insurance authorities might take action that would cripple the company." Perlman v. Commissioner, supra at 758. The troubled corporation in Perlman was in a situation similar to that of MFC. The shareholder forced to aid the corporation in Perlman was not deemed to have incurred a loss in his own trade or business; likewise, petitioner in the instant case cannot adopt the corporation's trade or business as his own to escape the limitations of section 163(d). See also Miller v. Commissioner, 70 T.C. at 459 n. 11. Accordingly, we conclude that the interest paid on loans incurred to purchase stock constitutes investment interest under section 163(d).

Two effective date rules apply to section 163(d). As originally enacted by the Tax Reform Act of 1969, section 163(d) applies only with respect to taxable years beginning after December 31, 1971. Pub. L. 91-172, section 221(a), 83 Stat. 574. Section 163(d)(5), however, provides the following transition rule:

This subsection shall not apply with respect to investment interest, investment income, and investment expenses attributable to a specific item of property, if the indebtedness with respect to such property--

> (A) is for a specified term, and
>
> (B) was incurred before December 17, 1969, or is incurred after December 16, 1969, pursuant to a written contract or commitment which, on such date and at all times thereafter prior to the incurring of such indebtedness, is binding on the taxpayer.

The second effective date rule was added in the Tax Reform Act of 1976. In general, the 1976 amendments apply to interest deducted in taxable years beginning after December 31, 1975. Pub. L. 94-455, section 209(b)(1), 90 Stat. 1543. The amendments do not, however, apply as follows:

> (b) EFFECTIVE DATE.--
>
> * * *
>
> (2) INDEBTEDNESS INCURRED BEFORE SEPTEMBER 11, 1975.--In the case of indebtedness attributable to a specific item of property which--
>
> (A) is for a specified term, and
>
> (B) was incurred before September 11, 1975, or is incurred after September 10, 1975, pursuant to a written contract or commitment which on September 11, 1975, and at all times thereafter before the incurring of such indebtedness, is binding on the taxpayer,
>
> the amendments made by this section shall not apply, but section 163(d) of the Internal Revenue Code of 1954 (as in effect before the enactment of this Act) shall apply. * * * [Pub. L. 94-455, section 209(b)(2), 90 Stat. 1543.]

Although petitioners did not raise this point in the pleadings, at trial or in their briefs, respondent has informed us that petitioners object to treating interest on unsecured demand notes and refinanced loans from periods preceding December 16, 1969, and September 10, 1975 as loans made after those dates.

Petitioners have nowhere alluded to this argument. The record contains no evidence describing the "unsecured demand notes" or the "refinanced loans." Respondent states that he can find no cases discussing these issues.

We are unable to consider adequately these important issues without evidence of the refinancing agreement, without argument by petitioner on brief or at trial, and without mention of the issue in the pleadings. Petitioners have met neither their burden of going forward with evidence nor their burden of proof. Rules 34(b)(4), (5) and 142(a), Tax Court Rules of Practice and Procedure; Welch v. Helvering, 290 U.S. 111 (1933); Helvering v. Taylor, 293 U.S. 507 (1935).

Issue 2. Treatment of Transfer of Rooming House to MFC in Exchange for Stock.

Until 1977, petitioner owned all of the common stock of MFC. In 1977, in a transaction not at issue in this case, petitioner transferred all of MFC's common stock to MEI, a newly organized corporation in which he was the sole shareholder. In 1978, petitioners held approximately 62 percent of the value of MFC's non-voting preferred stock.[5]

In 1978, petitioners transferred to MFC a rooming house which they had purchased in 1955. Petitioners' basis in the rooming house was $10,833.39. Petitioners valued the property at the time of the transfer at $150,000. The property was subject to liabilities in the amount of $111,493.52.

On April 24, 1978, petitioners paid to MFC $38,500 in exchange for 6,585 shares of non-voting preferred MFC stock. On April 25, 1978, petitioners received a check from MFC in the amount of $38,506.48, representing the difference between the $150,000 value of the rooming house and the $111,493.52 of liabilities to which the property was subject.

Petitioners contend that the transfer of the rooming house to MFC in exchange for stock qualifies for non-recognition under section 351. Respondent's position is that petitioners failed to meet the "control" requirements of section 351, and thus that the transaction should be treated as a sale. In the alternative, respondent argues that, even if section 351 applies, gain should be recognized to the extent that the liabilities assumed by the corporation exceed petitioners' basis in the property.

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[5] We assume in this discussion that petitioners held 62 percent of the value of non-voting preferred stock immediately after the 1978 transaction discussed infra.

We find that petitioners have failed to meet the section 351 control test. Section 351(a) provides that:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.* * *

Section 368(c) defines "control" as:

> [T]he ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Petitioner admits that immediately after he contributed the rooming house to MFC, MEI held all of MFC's voting stock. Petitioner argues, however, that MEI's holdings should be attributed to him, through section 318, since he held 100 percent of MEI's stock.

Section 318 attributes a proportionate share of the stock held by a corporation to its shareholders who hold 50 percent or more of its stock. Section 318 applies, however, only "[f]or purposes of those provisions of this subchapter [Subchapter C] to which the rules contained in this section are expressly made applicable." Section 318(a). Neither section 368(c) nor section 351 state that the attribution rules of section 318 apply. This Court has previously held that section 318 does not apply for purposes of determining control under section 351. Berghash v. Commissioner, 43 T.C. 743 (1965), affd. 361 F.2d 257 (2d Cir. 1966).

In addition, the stipulation establishes that petitioners held only approximately 62 percent of MFC's non-voting preferred stock immediately after the exchange. Petitioners therefore fail to satisfy both prongs of the control test.

In view of our holding that section 351 does not apply, we find it unnecessary to address respondent's alternative argument that even if section 351 were to apply, petitioners would be taxable to the extent the rooming house was subject to liabilities in excess of their basis.[6]

Issue 3. Character of Gain from Sale of Houses.

MFC loaned money to various developers of real estate. When one of the developers was unable to complete development of a project, petitioner decided to facilitate construction (and payment to MFC) by building seven homes himself. Five of the homes were sold after construction was complete, and petitioner reported the gain from their sale as ordinary income.

The two remaining homes were listed for sale for 2 years, but were not sold. In 1975, petitioner decided to hold the houses for rental while the real estate market remained depressed. From 1975 through 1978, he rented the properties to tenants. He did not install a sign on the properties indicating that they were being offered for sale, and he did not list the houses with a sales agency. In 1978, a buyer approached him, and ultimately purchased both houses. Petitioner reported the gain as long-term capital gain.

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[6] With respect to this claim, petitioners argued that they should not be treated as having received "boot" when MFC took the property subject to a mortgage because they were never personally liable on the mortgage. We note, however, that petitioners' basis in the property should have included the non-recourse liabilities to which the property was subject. Crane v. Commissioner, 331 U.S. 1 (1947). We assume that their stipulated basis of $10,833.39 had been adjusted for depreciation since 1955.

Respondent argues that petitioner held the properties primarily for sale to customers in the ordinary course of his trade or business. Section 1221. Petitioners contend that, beginning in 1975, they held the properties for investment.

We agree with petitioners. Whether realty is held for investment is an inherently factual question. Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968), affg. a Memorandum Opinion of this Court. Property acquired for one purpose may be held subsequently with a different intention. Biedenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1976).

Here petitioner admits that he originally acquired the property intending to sell it to customers as a real estate developer. When he was unable to sell two of the homes, however, he decided to abandon his effort at sales. He took active steps which serve as evidence of his changed intentions, by removing the homes from agency listings, and by failing to maintain a "For Sale" on the property. During the 3 years preceding the sale, the homes in question were not held for sale to customers in the ordinary course of petitioner's trade or business, and the gain on eventual sale of the property is therefore capital in nature.

To reflect our conclusions with respect to the disputed issues,

Decision will be entered under Rule 155.

JU11.7/2:1986-317

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T. C. Memo. 1986-317

UNITED STATES TAX COURT

SHELTON WORDEN RIGGS, JR. AND ROBERTA ROSE
RIGGS, Petitioners *v.* COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 9651-84. Filed July 28, 1986.

Held, Ps may not claim a charitable contribution deduction for certain amounts contributed to the First Church of Theophysics, a local chapter of the Universal Life Church, Inc., of Modesto, California. *Held further*, additions to tax under section 6653(a)(1), I.R.C. 1954, and section 6653(a)(2), I.R.C. 1954, sustained. *Held further*, damages under section 6673, I.R.C. 1954, awarded to the United States.

Shelton Worden Riggs, Jr. and Roberta Rose Riggs, pro se.

Catherine L. Campbell, for the respondent.

C. M.

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MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: Respondent determined a deficiency in and additions to petitioners' 1981 Federal income tax as follows:

	Additions to Tax	
Deficiency	Sec. 6653(a)(1)[1]	Sec. 6653(a)(2)
$9,098	$454.90	*

The issues for decision are: 1) whether petitioners are entitled to a charitable contribution deduction for amounts allegedly contributed to the First Church of Theophysics, a local chapter of the Universal Life Church, Inc., of Modesto, California; 2) whether petitioners are liable for additions to tax under section 6653(a)(1) and section 6653(a)(2); and 3) whether damages should be awarded under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Shelton Worden Riggs, Jr. (petitioner) and Roberta Rose Riggs (Roberta), husband and wife, resided at Sunnyvale, California, when they filed the petition herein.

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[1] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

* To be based on an underpayment of $9,098.

During 1981, petitioner worked as a computer software consultant for Advanced Electronics Design and Singer Company. He received compensation totalling $35,377.44 from these companies during 1981. During 1981, petitioner's wife received compensation of $18,879.83 from Acctex Corporation for services performed as a job counselor.

On July 3, 1978, petitioner received Charter No. 22122 from the Univeral Life Church, Inc., of Modesto, California. Petitioner was subsequently ordained a minister by the Universal Life Church on April 15, 1980, and soon thereafter started a local chapter of the Universal Life Church which he called the First Church of Theophysics (hereinafter sometimes referred to as FCOT).

Petitioner organized FCOT to teach a philosophy which he had developed called "Theophysics." Petitioner outlined his philosophy, which combined both physics and religion, in a book titled "Theophysics: The Scientific Basis for Religious Belief." Petitioner published 100 copies of his book and contributed all rights to the book to FCOT.

During 1981, a group of approximately three people regularly met at petitioners' residence on Sundays at 6:30 p.m. to discuss the philosophy of Theophysics. During these meetings, petitioner would also discuss computers as well as assist his son's friends in the preparation of their school work. Petitioners did not perform any marriages or baptisms during 1981. Petitioner, however, did counsel victims of tragedies.

During 1981, an account in the name of the First Church of Theophysics was maintained at Bank of America. Petitioners, who did not maintain any bank accounts in their own names, had signatory authority on the FCOT bank account.

During 1981, petitioners made cash payments totalling $30,975 to the FCOT bank account. During 1981, petitioners made the following payments with funds from the FCOT bank account:

Downpayment on residence purchased by petitioners in their individual capacity on September 11, 1981, for $144,000	$14,400.00
Closing costs incurred to purchase personal residence	5,000.00
Dryer, couch, refrigerator and carpets for personal residence	3,207.24
Rent on personal residence (Jan. 1, 1981-Sept. 21, 1981)	3,450.00
Mortgage on personal residence (Sept. 21, 1981-Dec. 21, 1981)	3,702.12
Utilities	244.03
Auto expenses	13.50
Donations (Universal Life Church, Modesto, California; UTEP; United Way)	100.00
Insurance	21.75
Repairs	75.00
Service charge on bank account	42.00
Miscellaneous	18.00
TOTAL	$30,273.64

On their 1981 Federal income tax return, petitioners claimed a charitable contribution deduction of $26,349.15 for amounts purportedly contributed to the First Church of Theophysics.[2] In the notice of deficiency, respondent disallowed this deduction in full.

OPINION

The first issue for decision is whether petitioners are entitled to a charitable contribution deduction for amounts allegedly contributed to the First Church of Theophysics, a local chapter of the Universal Life Church, Inc., of Modesto, California. Deductions are a matter of legislative grace and petitioners must satisfy the specific statutory requirements of the deductions that they claim. Deputy v. Du Pont, 308 U.S. 488 (1940); New Colonial Co. v. Helvering, 292 U.S. 435 (1934). Petitioners bear the burden of proving that they are entitled to the deductions that they claim. Rule 142(a).

Petitioners do not contend that they are entitled to a charitable contribution deduction for amounts contributed to the Universal Life Church, Inc., of Modesto, California. Rather, they contend that they are entitled to deduct certain amounts which they contributed to the First Church of Theophysics, a local chapter of the Universal Life Church which they created. Because the tax exemption granted to the Universal Life Church, Inc., of Modesto, California, is not a group exemption, Davis v.

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[2] During 1981, petitioners allegedly contributed $30,975 to the First Church of Theophysics. Section 170(d), however, generally limits an individual's charitable contribution deduction to 50 percent of his adjusted gross income. Petitioners therefore claimed on their 1981 return a charitable contribution carryover of $4,625.85 for 1982.

Commissioner, 81 T.C. 806, 815 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985), petitioners must establish that they made a contribution or gift to an organization which independently satisfies the requirements of section 170(c). This they have not done.

First, petitioners have not established that they made a gift or contribution during 1981. In order to make a legitimate gift, the donor must place the donated property outside his control. Davis v. Commissioner, supra at 813. In the instant case, petitioners had sole signatory authority on the FCOT bank account and had unrestricted use of the funds contributed to this account. Consequently, petitioners did not part with control over the funds allegedly contributed, and, therefore, they did not make a gift or contribution. Davis v. Commissioner, supra.

Moreover, even if petitioners had made a gift of the contributed funds, they have not established that FCOT satisfies the requirements of section 170(c). To satisfy the requirements of section 170(c), petitioners must establish, among other things, that no part of FCOT's net earnings (which include contributions made to FCOT) inured to their private benefit or the private benefit of other individuals. Section 170(c)(2)(C). During 1981, however, petitioners paid personal expenses totalling $30,273.64 with funds from the FCOT bank account. These expenses included a cash downpayment of $14,400 and closing costs of $5,000 which were incurred in connection with the purchase of petitioners' personal residence. They also used FCOT funds to purchase home furnishings and appliances and to pay their mortgage, utility bills, charitable contributions, automobile expenses and insurance premiums. These expenses all constitute personal living expenses which petitioners would have incurred regardless of whether they had established FCOT. As we stated in Miedaner v. Commissioner, 81 T.C. 272, 281 (1983), "[t]he church account was simply a magic wand whereby personal expenses were converted into tax deductions." Consequently, we find that the funds placed in the FCOT bank account were used for the personal benefit of petitioners. Petitioners, therefore, are not entitled to a charitable contribution deduction for amounts they allegedly contributed to the First Church of Theophysics during 1981.

In so holding, we have also considered and rejected petitioners' argument that the funds which they used to pay their personal expenses are equivalent to a parsonage allowance, and, therefore, that such payments do not constitute a prohibited inurement. Section 107 provides, in pertinent part, that:

> In the case of a minister of the gospel, gross income does not include--
>
> (1) the rental value of a home furnished to him as part of his compensation; or
>
> (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

Petitioners have presented no evidence that the payments of $30,273.64 which they made with FCOT funds represented the rental value of a home furnished to a minister of the gospel as part of his compensation or a rental allowance paid as part of a minister's compensation used by him to rent or provide a home. In light of the fact that petitioner worked full-time as a computer consultant and only held church meetings once a week, the amount withdrawn from the FCOT bank account was far in excess of any reasonable rental allowance petitioner would have received as compensation for his services as a bona fide minister. Even if we were to accept petitioners' contention that their residence constituted a parsonage, which we do not, the deduction would be disallowed as excessive. Excessive parsonage allowances are earnings of an organization which inure to an individual's benefit. Unitary Mission Church v. Commissioner, 74 T.C. 507, 514 (1980), affd. without published opinion 647 F.2d 163 (2d Cir. 1981); Hall v. Commissioner, 729 F.2d 632, 634 (9th Cir. 1984).

For the above reasons, respondent's disallowance of petitioners' charitable contribution deduction is sustained.

Respondent determined additions to tax under section 6653(a)(1) and section 6653(a)(2) for 1981. Petitioners offered no evidence that their underpayment of tax was not due to negligence or intentional disregard of the rules and regulations. Consequently, the additions to tax are sustained.

Finally, we must decide whether damages should be awarded to the United States under section 6673. Section 6673 provides that the Court may award damages of up to $5,000 to the United States whenever it appears that a proceeding has been instituted or maintained primarily for delay or that the taxpayer's position is frivolous or groundless. We think section 6673 damages are appropriate in this case. Petitioners' protestations of good intentions do not mask the staleness of their argument in support of their mail order church deductions, which have been repeatedly rejected by the Courts. Frivolous cases such as this clog the system and not only delay the assessment and collection of taxes rightfully due from petitioners, but also delay the consideration and disposition of meritorious cases by this Court. Damages are therefore awarded to the United States in the amount of $1,000.

To reflect the foregoing,

Decision will be entered
for the respondent.

JU11.7/2:1986-318

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T. C. Memo. 1986-318

UNITED STATES TAX COURT

MYRON G. SAMMONS AND DOROTHY SAMMONS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 21133-82. Filed July 28, 1986.

Petitioner husband paid $12,000 for a race horse which was never delivered. Efforts by petitioner and his attorney in 1977 to obtain delivery of horse or recovery of payment established that horse would not be delivered or money recovered.

Held, under California law where horse was purchased theft includes loss by embezzlement and petitioners are entitled to a theft loss deduction under section 165.

In 1977, petitioner gave two art dealers $140,000 with which to purchase for him a specific collection of Indian artifacts and deliver collection to a museum. Later petitioner discovered that the dealers paid only $60,000 for collection and demanded that the situation be rectified. Accordingly, dealers purchased and delivered more artifacts until they had spent almost all of the $140,000. All of the artifacts, some of which contained hawk and eagle feathers and parts, were delivered to museum by March 30, 1977. On December 6 petitioner told curator by telephone he wished to make gift last of month and in January 1978 curator gave him receipt dated December 30, 1977.

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Held, further, (1) the dealers were petitioner's agents and petitioner acquired title to all the artifacts because their purchase was within the scope of the agency; (2) even if the purchase of the items containing hawk and eagle parts violated Federal statute, such violation did not prevent the transfer of title to petitioners nor from petitioners to museum; (3) donation was completed on December 30, 1977; (4) expert appraisals are not acceptable at face value--one because of lack of independence and others because appraisals were made from photographs from which authenticity, age and condition of many items could not be determined; and (5) value of donation is $140,000 because the most reliable evidence of the fair market value of artifacts was the amount paid by petitioner.

Held, further, petitioners are liable for the addition to tax for negligence provided by section 6653(a) because reliance, by petitioner husband, an intelligent, successful and prudent businessman, upon appraisals of over $500,000 for items which he paid only $140,000 was not the act of a reasonable and ordinarily prudent person.

James Powers and Marc L. Spitzer, for the petitioners.

David W. Otto, for the respondent.

MEMORANDUM FINDINGS OF FACTS AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

Year	Deficiency	Additions to Tax Section 6653(a)[1]
1977	$ 140,659.72	$ 7,032.98
1978	95,853.94	4,792.69
1979	165,546.60	8,277.33

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure unless otherwise provided.

After concessions, the issues for decision are: (1) whether petitioners are entitled to a deduction for the nondelivery of a race horse for which they paid $12,000; (2) whether petitioners are entitled to a deduction for a contribution to Pacific Northwest Indian Center, and if so, the amount of such deduction; and (3) whether any part of any deficiency due from petitioners is attributable to their negligence or intentional disregard of rules and regulations within the meaning of section 6653(a).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioners, Myron G. and Dorothy Sammons, are husband and wife. For the years 1977, 1978 and 1979 they filed joint income tax returns with the Internal Revenue Service Center at Ogden, Utah. For several years prior to the end of 1976 they lived in Missoula, Montana, where Myron G. Sammons ("Sammons") owned and operated a trucking business which he sold at a substantial profit in September 1976. Petitioners moved from Missoula to Scottsdale, Arizona in late 1976 and continued to reside there throughout the years in issue and at the time they filed their petition herein.

In November 1976, Sammons met Joe Shearer at the Santa Anita Race Track in Los Angeles to examine some thoroughbred race horses which Shearer was offering to sell as agent for an undisclosed owner. During the meeting, Sammons gave Shearer a check for $32,000 of which $20,000 was in payment for a race horse named "Wind Marhiai" and $12,000 was in payment for a second unnamed race horse. Early in 1977, Shearer delivered Wind Marhiai to Sammons. The second race horse was never delivered.

After some delay Sammons concluded that Shearer had no intention of delivering the second horse and attempted to contact Shearer at Santa Anita and later at the Bay Meadows Race Track in San Francisco. Being unsuccessful in these attempts, Sammons instructed his attorney Ralph Wright to take whatever legal action was necessary in order to recover the $12,000. Wright's efforts also proved unsuccessful, and after consultation with him in 1977, Sammons concluded the second horse would never be delivered, any further action was useless, and the $12,000 could not be recovered.

From 1966 through the years in issue, the Pacific Northwest Indian Center, Inc. ("Indian Center") operated a museum in Spokane, Washington known as the Museum of Native American Cultures ("MONAC"). The museum features exhibits and collections of Indian artifacts which portray the history and culture of North American tribes. Wilfred P. Schoenberg ("Schoenberg"), a Jesuit priest and the founder of the Indian Center, was serving in 1977 as its president and as the curator of MONAC. Throughout 1977, the Indian Center was recognized by respondent under section 170(c) as a qualified charitable organization exempt from taxation under section 501.

Schoenberg made a practice of encouraging investors to buy artifacts and contribute them to the Indian Center. He distributed letters outlining tax writeoffs for the contribution of property where the fair market value of the property on the date of its contribution was greater than its cost. His letters to potential donors included statements to the effect that fair market value meant the highest price that "someone, somewhere" would offer for an object.

In January of 1977, Schoenberg became aware that a collection of Indian artifacts known as the Stuart Collection was owned by Joan Berry ("Berry")[2] who lived in Kalispell, Montana, and that the collection might be available for contribution to the Center. This collection consisted of a number of artifacts, primarily from the Plains and Plateau Indians. It included painted buffalo hides, buckskin clothing, medicine pipes, war bonnets, snow shoes, bayonets (presumably taken in battle), baby carriers, human scalps, horse tails, medicine rattles made from buffalo scrotums, cradle boards, bone tools, such as elk bone hide scrapers, and numerous other items.

The most significant item in the Stuart Collection was a rare Blackfoot medicine pipe bundle known as a "thunder pipe." It contained a number of items wrapped together in a single hide or bundle. Among the items were a sacred medicine pipe, various medicine bags, an ermine pelt, the bodies of two weasels, an effigy head of a crane, a bone dance whistle, deer bones, a feather bundle with hawk bells, other feathers, medicine wands used for gambling, braided sweet grass, a child's buckskin moccasin with medicine stones inside, a flute made from a rifle barrel and other artifacts.

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[2] At certain points in the record Joan Berry is also referred to as Joan Kelly.

Thunder pipes generally have important religious significance to members of the Blackfoot tribe. It is believed that they embody great power for the tribe, as well to as any individual who is the "holder" of a pipe. The pipes are used ceremoniously during the first thunderstorm in the spring of each year, as well as on feast days specifically honoring the pipes. Each holder has the perogative, after appropriate fasting and inspiration, of adding items to his bundle.

In keeping with a thunder pipe's religious function and to keep it from being desecrated, it is traditionally passed from one holder to another during a special ceremony.

The Stuart who originally assembled the collection which bears his name was a policeman on a Blackfoot reservation and allegedly acquired his thunder pipe from a Blackfoot Indian in the 1930's without the traditional ceremony, but fearing for the health and well-being of the Indian who had improperly passed the pipe, fellow tribesmen surrounded Stuart's house and demanded that a proper pipe-passing ceremony be performed. Thereupon a feast was prepared and the pipe was ceremoniously passed to Stuart. Nevertheless, several years later Stuart purportedly disregarded its ceremonial purposes and unwrapped the bundle to display its contents in a gift shop which he owned. Shortly thereafter, he broke his leg, developed a very painful infection and died. His widow, Laura Stuart, sold the thunder pipe to Joan Berry, passed it to Ms. Berry without a proper ceremony, and within a month choked to death while dining with friends. In 1977 Joan Berry still owned the pipe and the balance of the Stuart Collection.

Upon learning of the possible availability of the Stuart Collection Schoenberg contacted Dolores Swanberg ("Swanberg"), an art dealer in Kalispell, and believed by Schoenberg to be an acquaintance of Berry. They discussed generally the Indian Center's "local system for tax write-off gifts." By letter dated January 26, 1977, Schoenberg advised Swanberg of the availability in her area of a certain collection of Indian artifacts with a "possible fair market value appraisal of $500,000," which appraisal could be provided by a group of appraisers that the Indian Center had organized for this purpose. He further stated that the collection was available at a price "reasonable enough to attract investors." Schoenberg was referring to the Stuart Collection. Swanberg told Connie Jo Dalby ("Dalby"), another Kalispell art dealer, that Schoenberg was interested in obtaining the Stuart Collection for the Indian Center. Dalby telephoned Schoenberg and was also told by him that the Stuart Collection could be appraised at $500,000. At this point, Dalby and Swanberg became partners or joint venturers for the purpose of locating an individual to purchase the Stuart Collection and contribute it to the Indian Center.

After unsuccessfully contacting several attorneys and accountants in Montana about a possible purchaser Dalby, in early February of 1977 contacted Jack Dobbins ("Dobbins"), a C.P.A. with offices in Missoula and inquired whether he had a client who would be willing to invest $140,000 to acquire an artifact collection which could be contributed to a museum at an appraised value of about $500,000. Dobbins told Dalby that he would consider the matter.

At about the same time Sammons in Scottsdale was informed by his attorney, Ralph Wright, that he had learned of a "tax shelter" involving a collection of Indian artifacts which could be bought for about $140,000 and donated to the Indian Center at an appraised value of $500,000. Sammons instructed Wright to discuss the proposed transaction with his accountant, Jack Dobbins. In doing so, Wright learned that Dobbins had already been contacted about the collection by Dalby. Wright and Dobbins then advised Sammons that the proposed purchase of the collection for $140,000 and its contribution to the Indian Center at $500,000 appeared to be an appropriate transaction for Sammons and his wife. Sammons then instructed Dobbins and Wright to contact Dalby and proceed with the transaction.

In the meantime, Swanberg had approached Berry with an offer to purchase the Stuart Collection for $125,000. Berry, however, refused to sell at that figure because, according to Berry, she had just received two appraisals of the Stuart Collection which did not justify a sales price of $125,000. Further negotiations resulted in an agreement by Swanberg to purchase the collection from Berry for $60,000.

On February 9, 1977, Dobbins paid Dalby $140,000 and in return was given a receipt which reads as follows:

> "THE UNDERSIGNED does hereby acknowledge receipt of the sum of ONE HUNDRED FORTY THOUSAND AND NO/100 DOLLARS ($140,000.00) from MYRON G. SAMMONS and DOROTHY SAMMONS, As Tenants in Common, with an express 60% ownership in Myron G. Sammons and an express 40% ownership in Dorothy Sammons, the same representing payment in full for the purchase of that certain art collection herein known as THE STUART COLLECTION.
>
> Upon receipt of this payment, the said Stuart Collection will be transported to the Northwest Indian Center, operated by the Museum of Native American Cultures in Spokane, Washington, where it will be held in safekeeping and on loan by the Sammons family, and where a full and complete inventory and photographs of said Collection will be made, and copies of said inventory and photographs will be provided to Myron G. Sammons and Dorothy Sammons within thirty (30) days from the date hereof.
>
> DATED this 9th day of February, 1977.
>
> /s/
> Connie Jo Dalby

The next day, February 10, 1977, Swanberg gave Berry a cashier's check for $60,000 in full payment for the Stuart Collection with the understanding that Berry would deliver the collection to the Indian Center. The delivery was made by Berry on February 24 and on February 26, 1977, Sammons wrote Schoenberg as follows:

> My wife and I are the owners of a substantial collection of Indian artifacts, which you may find desirable as an exhibit in your museum. * * *

> The collection is very expensive to insure and preserve; and for this reason, we would be willing to loan it to the museum and allow it to be exhibited as long as the museum would guarantee to maintain insurance for the appraised value of the collection and guarantee to keep the collection in a suitable environment to safeguard and preserve the ancient leathers, inks, dyes, and other organic parts of the individual pieces.
>
> We would, of course, expect the museum to provide us with an appraisal for determining the amount of the insurance necessary to insure the collection. If the museum would be in agreement to the above terms and conditions and would like to exhibit our collection, please contact me at our Scottsdale address.

Apparently in reply to Sammons' letter of February 26, Schoenberg on March 9 wrote Dalby that the Stuart Collection was in his museum vault and was being carefully guarded and covered by insurance.[3] He further stated that "[w]hile it will take many days to assess the exact value of this collection, it appears at this point that the total value will be $500,000.[4] I trust that this will reassure your client."

At about this same time Sammons learned in Scottsdale from one of his employees that the Stuart Collection which he had just purchased had, by a remarkable coincidence belonged to Berry, an acquaintance of his in Montana. Having also been informed that the price he paid might have been inflated he called Berry. Upon learning from her that she received only $60,000 for the collection for which he simultaneously had paid $140,000 Sammons concluded that he "got took."

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[3] The record contains no evidence that the collection was ever insured at any specific figure by the museum. Apparently Schoenberg was referring to coverage by some type of blanket policy owned by the museum.

[4] Contrary to this statement, at trial Schoenberg testified that upon receipt of the Stuart Collection he immediately protested that it was not sufficient to warrant an appraisal of $500,000.

Immediately thereafter, Sammons telephoned Dalby and informed her in a few words that he had learned how much she paid for the Stuart Collection, that he thought the collection was not as valuable as Swanberg and Dalby had indicated, and that he expected her to "do something about it." Dalby, being extremely unnerved and shaken by her conversation with Sammons, contacted Swanberg and with her help and financial assistance purchased through Mannie Moore, the co-owner of an Indian art gallery in Rollins, Montana, a collection known as the Flathead Trading Post Collection. The Flathead Collection consisted of artifacts of the Indians of the Northern Plains and a collection of stone tools and weapons. Dalby and Swanberg paid $45,000 for Moore's collection and delivered it to MONAC on March 23, 1977.

After receiving the Flathead Collection, Schoenberg advised Dalby and Swanberg that the combined value of the Flathead Collection and the Stuart Collection was less than $500,000 and suggested that they obtain and deliver additional artifacts so that the total appraised value would exceed $500,000. Pursuant to his suggestion, Dalby and Swanberg obtained additional items from their own collections and from others and delivered them to Schoenberg. The additional items, the cost of which almost consumed but did not exceed, the balance of the $140,000 which Swanberg and Dalby had received from Jack Dobbins, included Indian pipes, a German furtrader's silver collection, a collection of Indian photographs and various archaeological pieces. All of the items were delivered to the Indian Center and placed in its vault by March 30, 1977. By letter dated April 2, 1977, Schoenberg advised Sammons that MONAC had received a collection of artifacts with a fair market value in excess of $500,000.

In June 1977, Schoenberg had all of the artifacts in the collection inventoried and individually photographed. In July and August 1977, he had them appraised by Walter Crawford, Patsy Converse Bates, and Stu Barrett. Crawford concluded that the collection had a total fair market value of $540,185. Bates' appraisal was $548,380. The amount of Barrett's appraisal is not in the record. For their services the appraisers received no remuneration determined by reference to the amounts of their appraisals. However, each of the appraisers received, either free of charge or by way of discounted value, artifacts deaccessioned[5] by the Indian Center.

By letter dated September 2, 1977 Schoenberg forwarded to Sammons copies of the appraisals, photographs of the artifacts, a copy of the museum's form letter containing tax deduction information, and an undated receipt reflecting a contribution of the artifacts to the museum which receipt according to the letter was "to be signed and dated at the appropriate legal time." The letter concluded as follows:

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[5] Deaccessioning is the process by which artifacts or similar items owned by a museum are disposed of either through sale or exchange.

> Mostly I want to thank you. Formalities of ownership are not complete, I know, but we truly appreciate what you have already done. Be assured that if any question on values arises, we will back you up with legal and anthropological support.
>
> If and when you are interested in additional tax investments please let me know. Many collections and items come to our attention.

On December 6, 1977, Sammons telephoned Schoenberg and stated that he and his wife wished to make a gift to the Indian Center of all of their artifacts then stored in MONAC's vaults with the gift being effective as of "the last part of the month." On January 26, 1978 Schoenberg sent Sammons a receipt dated December 30, 1977. The receipt recited that a contribution had been made by the Sammonses to the Indian Center of the following:

The Stuart Collection

The Mannie Moore Collection from the Flathead Lake Museum

The Connie Dalby Collection

A German Silver Collection

A Collection of Photographs and Manuscripts

A Stone Collection from the Flathead Lake Museum

Prehistoric Ivory and Bone Artifacts

Archeological Treasures from the Swanberg Collection

From January 1, 1978, the collection of artifacts which contained 447 items was known as the Myron G. Sammons Collection. It was displayed as part of MONAC's exhibits and in furtherance of the Indian Center's charitable purposes. However, between

January 1978 and January 1983, MONAC deaccessioned many items in the Sammons Collection until by January 1983, only twenty items, including the thunder pipe, remained.

On their 1977 income tax return, petitioners claimed a deduction for a theft loss of $11,900 ($12,000 less the $100 deductible) with respect to the race horse which was never delivered. They also claimed a deduction for a contribution to the Indian Center of $548,380 which, because of annual limitations, was limited to $192,108 in 1977 and carried over into 1978 and 1979 in the respective amounts of $164,027 and $192,245.

Respondent disallowed both deductions for lack of substantiation and determined that petitioners are liable for additions to tax under section 6653(a) because their deficiencies in tax are attributable to negligence or the intentional disregard of applicable rules and regulations.

OPINION

Theft Loss

During 1977 petitioners paid $12,000 for a race horse which was never delivered. Petitioners were unable to recover the $12,000 or find the individual to whom it was paid.

Under section 165(c)(3), an individual is permitted to deduct a theft loss to the extent that the amount of such loss exceeds $100. The deduction includes losses by embezzlement. Section 1.165-8(d), Income Tax Regs. Section 503 of the Penal

Code of California, where the loss occurred, defines embezzlement as the fraudulent appropriation of property by a person to whom it has been entrusted.

The burden of establishing both the existence of the theft and the amount of the loss is on petitioners. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Respondent contends that petitioners have failed to substantiate that a loss occurred or if so, the amount thereof. We disagree. Mr. Sammons testified in a candid, credible and forthright manner concerning the purchase from Shearer of the two horses, one for $20,000 and one for $12,000, the payment of the $32,000, the nondelivery of the second horse and his unsuccessful efforts and those of his attorney to find Shearer in order to receive delivery of the horse or recover the money. Shearer's appropriation of the $12,000 constituted an embezzlement under California law, and theft under section 165(c)(3) includes embezzlement. Consequently, petitioners are entitled to a loss deduction in the amount of $11,900.

Contribution to Indian Center

With respect to this issue the parties agree that during 1977 the Indian Center was qualified under section 170 to receive tax deductible contributions. The parties also agree that such a contribution can be made in property. They disagree in this case as to the property actually contributed and the value of such property. These are questions of fact on which petitioners have the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933).

Respondent first contends that petitioners did not acquire title to all of the 447 items which were delivered to MONAC because Dalby and Swanberg were only authorized to purchase the Stuart Collection for Sammons and that the "moral obligation" which compelled them to purchase and transfer the additional artifacts was not sufficient to place title to the additional items in Sammons. Petitioners contend that the scope of the agency was to acquire artifacts that would be appraised by Schoenberg's appraisers at $500,000 for purposes of obtaining a deduction and consequently all of the artifacts delivered to MONAC were acquired by Dalby and Swanberg as agents for Sammons.

It is a well-settled principle that in determining ownership of property, state law controls. United States v. Mitchell, 403 U.S. 190, 197 (1971). More specifically, the rights and duties of a principal and agent toward each other are also determined by the law of the state which, with respect to the particular issue, has the most significant relationship to the parties and the transaction. See William B. Tanner Co., Inc. v. WIOO, Inc., 528 F.2d 262 (3d Cir. 1975); P.S. & E., Inc. v. Selastomer Detroit, Inc., 470 F.2d 125 (7th Cir. 1972). Since all of the significant acts with respect to the relationship transpired in Montana, except the actual delivery of the artifacts to the Indian Center,[6] we turn to Montana law in order to determine the scope of the agency in this case.

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[6] Even the delivery was pursuant to an agreement reached in Montana.

Under Montana law, "[a]n agency may be created and an authority may be conferred upon a precedent authorization or subsequent ratification." Montana Code Annotated section 28-10-201 (1985). Montana law further provides that "[a]n agent has such authority as his principal actually or ostensibly confers upon him," including doing "everything necessary and proper and usual, in the ordinary course of business, for effecting the purpose of his agency." Montana Code Annotated section 28-10-401, 405 (1985). The Supreme Court of Montana has consistently followed the rule of law that an agency "may be implied from conduct and from all the facts and circumstances in the case, and may be shown by circumstantial evidence. * * * Also, ratification may be implied from the acts and conduct of the alleged principal." Butler Manufacturing Co. v. J & L Implement Co., 167 Mont. 519, 540 P.2d 962, 965 (1975).

Our findings conclusively demonstrate that Dalby and Swanberg consented to act on behalf of Sammons, that Sammons through Wright and Dobbins agreed to the arrangement, and that Sammons conferred upon Dalby and Swanberg as agents the authority to acquire and deliver to Schoenberg artifacts which Schoenberg's appraisers would appraise at $500,000. Therefore, the acquisition by Dalby and Swanberg of the Stuart Collection, the Flathead Collection and all of the other artifacts which eventually became known as the Myron G. Sammons Collection was "necessary and proper and usual to effect the purpose of the agency." As a result, Sammons had acquired title to all of the artifacts by March 30, 1977, the date by which all of the artifacts were delivered to MONAC.

Respondent next contends that since Federal law prohibits the purchase or sale by an individual of certain bird feathers and appendages (including those of eagles and hawks), petitioner could not take title to 35 of the Indian artifacts (including the thunder pipe). Consequently, according to respondent the transfers of these items to petitioners and from petitioners to the Indian Center are void. See 16 U.S.C. Sections 668-668(d) (Bald Eagle Protection Act); 16 U.S.C. Sections 703-711 (Migratory Bird Treaty Act); and 16 U.S.C. Section 1531 (Endangered Species Act). Petitioners counter that even if the transfer of these items is a violation of Federal law, the violation does not void the transfer of title to petitioners nor from petitioner to the Indian Center. We agree with petitioners because the statute relied upon by respondent merely provides that items transferred in violation of the statute are only subject to forfeiture.[7] 16 U.S.C. sections 668, 668b, 707 and 1540(a)(e).

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[7] It is hornbook contract law that "[w]here a performance has been entered under an illegal bargain, the general rule is that the Court will leave the parties to the illegal bargain where it finds them." Calamari & Perillo, Contracts, p. 567. Williston states: "It is doubtless possible for the law to make even an attempted executed sale with transfer of possession so absolutely void that no title passes to the buyer; but the mere fact that a sale is against public policy or in violation of a statute does not have this effect." 15 Williston on Contracts, section 1787 (3d ed. 1972). This rule seems to have been incorporated by the Federal statutes in issue as the items themselves are only "subject to forfeitures." 16 U.S.C. sections 668, 668b, 707 and 1540(a)(e) (1982). (Emphasis added.)

We also disagree with respondent's assertion that Sammons failed to make a valid gift of the artifacts to the Indian Center in 1977. We have found that on December 6, 1977 Sammons told Schoenberg by telephone that he and his wife wished to donate the artifacts to the Indian Center effective as of the end of December 1977. Since the Center had possession of the items at that time and formally accepted them as of December 30, 1977, we are satisfied that petitioners completed the contributions in 1977. See Ariz. Rev. Stat. Ann. section 33-601 (1974)[8] which provides: "[a] gift of any goods or chattels is not valid unless the gift is in writing, duly acknowledged and recorded, or by will, duly proved and recorded, or unless actual possession of the gift is passed to and remains with the donee or someone claiming under him." If the donor manifests an intent to give the property to the party claiming to be the donee and the latter is given full possession and control of the property prior to the donor's death, then there exists a valid inter vivos gift. Elkins v. Vana, 25 Ariz. App. 122, 541 P.2d 585 (1975).

Finally, respondent contends that petitioners failed to establish the value of their contribution to the Indian Center. Where as here, a contribution is made in property other than money, the amount of the contribution is the fair market value of the property as of the date contributed, reduced when necessary as provided in section 170(e)(1).[9] The generally accepted definition of fair market value is set forth in respondent's regulations as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Section 1.170A-1(c)(2), Income Tax Regs. Fair market value as of any given date is a question of fact to be resolved by considering all relevant evidence in the record.[10] Kaplan v. Commissioner, 43 T.C. 663, 665 (1965). Here again, petitioners have the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

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[8] The artifacts, though located in the State of Washington from March 30, 1977 to December 30, 1977, are deemed to have been located in Arizona during this period because the situs of personal property is the domicile of the owner. In re Estate of Grady, 79 Wash. 2d 41, 483 P.2d 114 (1971).

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[9] Section 170(e)(1) provides in pertinent part that:

> (1) General Rule.--The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of--
>
> > (a) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), * * *.

In 1977, section 1222 provided that gain from the sale or exchange of a capital asset held for more than nine months was to be treated as long term capital gain. Although we have found that petitioners owned all of the artifacts for at least nine months, the application of section 170(e)(1) is of no consequence due to our holding on this issue.

As set forth in our findings Schoenberg had the entire Sammons Collection inventoried, photographed, and appraised in June, July and August of 1977. The appraisals were made by Walter Crawford, Patsy Converse Bates, and Stu Barrett. Normally, such appraisals would be entitled to considerable weight since they were made shortly after the collection was assembled, near the time the collection was given to the Center, and while the collection was still completely intact. However, neither Bates nor Barrett testified at the trial. Consequently, we are unable to attribute any weight to their conclusions. Walter Crawford did testify at the trial, but for the reasons hereinafter set out we are unable to accept his appraisal at face value because we have serious reservations about his independence.

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[10] The fair market value of art can be the subject of considerable disagreement among appraisers. See Neely v. Commissioner, 85 T.C. 934 (1985); Anselmo v. Commissioner, 80 T.C. 872 (1983), affd. 757 F.2d 1208 (11th Cir. 1985).

The Tax Reform Act of 1984 amended section 6659 so as to provide increased additions to tax for valuation overstatements, reporting requirements for charitable donees which receive property and dispose of it within two years and detailed appraisal requirements. When applicable, the statute requires the donor to obtain a "qualified appraisal" which, pursuant to the Temporary Regulations, means the appraisal must have been conducted by a qualified appraiser not earlier than 60 days prior to the contribution. Section 6659(f); section 1.170A-13T(c)(3)(i)(A), Temporary Income Tax Regs., 48 Fed. Reg. 50659 (Dec. 31, 1984). A qualified appraiser is an appraiser who was not a party to the transaction in which the donor obtained the property nor related to any person whose relationship to the donor would cause a reasonable person to question their independence. See section 1.170A-13T(c)(5), Temporary Income Tax Regs., 49 Fed. Reg. 50659 (Dec. 31, 1984).

Mr. Crawford has been a collector, dealer, and trader in Indian artifacts and other materials since 1923. During his career he has made between 2,000 and 3,000 appraisals of Indian objects. He is particularly experienced with respect to the artifacts of the Southwest tribes, but he has made about 100 appraisals all for MONAC of artifacts from the Plains and Plateau Indians.

However, at the time Mr. Crawford made the appraisal in this case he was MONAC's vice president and its appraisal representative in the Phoenix area. Furthermore, he had known Schoenberg for many years and had made numerous appraisals for him and the Indian Center, either at no cost or in exchange for a gift of museum items or the opportunity to purchase such items at a discount. Also at or about the time of his appraisal of the Sammons Collection at least 70 other collections were being assembled by or for Schoenberg under circumstances which would lead to questionable donations to the Indian Center. The existence of these circumstances raises serious reservations about Mr. Crawford's independence and, as previously stated, we are unable to accept his appraisal at face value.

In support of their evaluation of the Sammons Collection, petitioners also called as expert witnesses Dr. Frederick J. Dockstader and Mr. Alton R. Packard who submitted a joint appraisal report in which they assigned a fair market value as of December 1977 of $422,410 to the collection.

Dr. Dockstader spent a great deal of his childhood on the Navajo and Hopi Indian reservations in Arizona. He later earned both a bachelor's degree and a master's degree from Arizona State University. He also has a Ph.D in American Studies from Western Reserve University in Cleveland, Ohio. Since finishing school he has served in a number of positions with various museums, organizations, and universities. He is a prolific writer and is the author of a number of books and articles on the American Indian and Indian art. At the time of the trial of this matter Dr. Dockstader was serving as an adjunct professor of art history at Arizona State University and as a consultant to various museums and collections in the United States and Canada.

On the other hand, Mr. Packard's expertise has been obtained from his experience as a merchant and dealer since 1955 in Indian artifacts in Santa Fe, New Mexico. He graduated from the University of New Mexico with a major in geology and a minor in anthropology and has served as a judge at numerous Indian art competitions. He was also commissioned to install an Indian artifacts exhibition at the Smithsonian Institution in Washington. At the time of the trial of this matter Mr. Packard was a member of the International Society of Appraisers and had appraised more than 2,500 Indian art collections.

From the foregoing, it is apparent that Dr. Dockstader and Mr. Packard are also qualified to appraise a collection of Indian art and artifacts. They readily admit, however, that in making their appraisal in this case they were seriously handicapped by the fact that they were unable to inspect 427 of the articles in the Sammons Collection. Instead, with respect to these articles they had to rely upon the photographs made under Schoenberg's supervision in 1977. However, they both testified that an appraisal made solely from photographs has serious limitations. For instance, according to their testimony, from photographs only it is difficult, if not impossible, to determine the condition, authenticity, or the age of artifacts. Therefore, since they were forced to work for the most part from photographs, they qualified their joint appraisal by stating that it was based upon the assumption that the items in the collection were genuine and in average to good condition. With this assumption in their report we are unable to accept their appraisal at face value.

Respondent called as an expert witness Laurence Tyler, a dealer in Plains and Plateau Indian artifacts since 1964. His education includes a bachelor of art's degree and two years of graduate study in anthropology at the University of Washington. In making his appraisal Mr. Tyler personally examined several pieces of the Sammons Collection at MONAC in January of 1983. He also personally viewed an additional piece in April of 1983. In October of 1983 and in January of 1984 he observed all of the photographs made in 1977 of the entire Sammons Collection.

Questioning the authenticity and condition of most of the items in the collection and citing a number of comparable sales, Mr. Tyler testified that in his opinion the 1977 fair market value of the Sammons Collection was between $66,000 and $100,000. He also testified that an appraisal based upon photographs has limitations because of the inability to determine the age and condition of the artifacts. Since 80 percent of his appraisal is based upon photographs, we are again unable to accept the evaluation at face value.

For the reasons set forth hereinbefore we are unable to adopt the appraisal made by any one of the experts. However, from the record as a whole we are satisfied that in 1977 the collection had a fair market value in excess of that found by Mr. Tyler, respondent's expert, but considerably less than the values found by Dr. Dockstader, Mr. Parker, and Mr. Crawford, petitioners' experts. In fact, a careful review of the entire record fails to disclose any competent and fully reliable evidence as to the fair market value of the collection in 1977 other than the amount paid for the collection by Dalby and Swanberg on the one hand and by Sammons on the other. According to the uncontradicted testimony of Dalby the total amount paid by Dalby and Swanberg was almost, but not more than, $140,000. The amount paid by Sammons was exactly $140,000. We conclude, therefore, that the total value of the Collection on the date in March of 1977 when the last delivery was made to the Indian

Center was $140,000. We also conclude the total value of the collection did not change prior to its donation by petitioners to the Center in December of 1977.

In arriving at the above conclusions, we have considered petitioners' arguments to the effect that the value of the Collection increased between its delivery and its donation because of appreciation or because all of the various items were brought together into a collection. We find these arguments unpersuasive, however, primarily because petitioners own experts testified to the contrary.

Addition to Tax Under Section 6653(a)

Finally, we must determine whether any part of the deficiencies due from petitioners is attributable to their negligence or intentional disregard for rules and regulations within the meaning of section 6653(a). Under this section "[n]egligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances." Neely v. Commissioner, 85 T.C. 934, 947 (1985); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967).

Respondent contends that petitioners are liable for the addition to tax provided by section 6653(a) because their reliance upon the appraisals furnished by Schoenberg constituted negligence. Petitioners contend that throughout the entire transaction they relied upon the advice of their lawyer and accountant and as a result they were not negligent and did not intentionally disregard any rules and regulations.

It is true that under certain circumstances a good faith reliance on the advice of a tax advisor may constitute a defense to the addition to tax provided by section 6653(a). See Conlorez Corp. v. Commissioner, 51 T.C. 467, 475 (1968). Generally speaking, however, a taxpayer cannot avoid the responsibility of filing accurate income tax returns by relying upon an agent. Bailey v. Commissioner, 21 T.C. 678 (1954).

We have found that Mr. Sammons successfully operated a truck business for several years, that he sold the business at a substantial profit in 1976, and that he quickly and prudently eliminated what he considered was an unreasonable profit by Dalby and Swanberg on the acquisition of the Stuart Collection. Furthermore, from his demeanor at trial we are convinced that he is a reasonably intelligent individual. Consequently, we are compelled to conclude that Mr. Sammons, as an intelligent, prudent, and successful businessman knew or reasonably should have known that the appraisals obtained by Schoenberg were considerably greater than the fair market value of the collection. He, however, chose to accept as true the appraisals of over $500,000 for a collection of objects which he had just purchased for $140,000. Under the circumstances, we believe that such action by him is not the act of a reasonable and ordinarily prudent person. *Neely v. Commissioner*, *supra*. The assertion of the addition to tax under section 6653(a) is sustained.[11]

Decision will be entered

under Rule 155.

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[11] For the years under consideration here, about 70 to 80 donations made to MONAC were questioned by respondent. See *Johnson v. Commissioner*, 85 T.C. 469 (1985), involving donations to MONAC and where we asserted, sua sponte, an addition to interest under section 6621(d).

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UNITED STATES TAX COURT

ROBERT R. WOTT AND CYNDY A. WOTT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19455-82. Filed July 28, 1986.

Bernard Wiczer, for the petitioners.

Julia M. Dewey, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KÖRNER, Judge: Respondent determined deficiencies in Federal income tax against petitioners as follows:

Taxable Year Ended	Deficiency
December 31, 1975	$ 4,215
December 31, 1976	3,221
December 31, 1977	5,179
December 31, 1978	9,265

ORIGINAL

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The issues presented for decision are: (1) Whether petitioners are entitled to claimed business expenses in connection with the operation and maintenance of a 44-foot motor yacht during 1978; (2) whether petitioners are entitled to a claimed depreciation deduction for 1978 with respect to the yacht; and (3) whether petitioners are entitled to an investment tax credit in connection with the purchase of the yacht in 1978; if yes, whether the investment tax credit may be carried back to petitioners' taxable years 1975, 1976, or 1977.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Robert R. Wott ("Robert" or "petitioner") and Cyndy A. Wott ("Cyndy") were husband and wife and residents of Palos Heights, Illinois, at the time the petition herein was filed. Robert and Cyndy (hereinafter referred to, collectively, as "petitioners") filed joint Federal income tax returns for their taxable years 1975 through 1978, inclusive, using the cash receipts and disbursements method of accounting. During the years in issue, Robert was a practicing certified public accountant and Cyndy was a beautician.

Robert was first employed by George Bagley & Co. (sometimes referred to as "the partnership"), an accounting firm, in 1962 and became a partner in 1971. The business offices of George

Bagley & Co. were located at 135 South LaSalle Street, Chicago, Illinois. Facilities at that location included conference rooms and private offices for the partners.

On May 1, 1977, the partners of the firm, including Robert, entered into an amended partnership agreement. The agreement provided that the partners were responsible for promotional and local travel expenses incurred by them. Expenses incurred by the partners in attending conventions, or in connection with business entertainment of employees of the First National Bank of Chicago, of colleges, or of business schools were to be considered a firm expense. All other funds expended for the business of the partnership were to be reimbursed to the partners by the partnership.

In June 1978, petitioner purchased a new 44-foot Trojan motor yacht from Rodi Boat Company, Chicago, Illinois. Robert traded in his 1974 36-foot Trojan tri-cabin boat for the 44-foot yacht. Petitioners agreed to pick up the yacht at Elkton, Maryland, and because of this they were given a credit of $5,000, representing launching and handling costs (including delivery costs), towards the purchase price of the yacht. The yacht had to be brought from Elkton, Maryland, to New Buffalo, Michigan, used by petitioner as his home port.

Horizon Credit Corporation financed a substantial part of the purchase price of the yacht. Robert represented to Horizon that the yacht was to be used for personal, family, or household purposes. William Youngquist, Robert's partner, loaned Robert $10,000 to purchase the yacht.

Cyndy had no boating experience prior to her marriage to Robert in 1970. Her role aboard the yacht was that of a hostess, preparing and serving food and entertaining the spouses and children of the guests aboard the yacht.

Petitioners picked up their yacht at Elkton, Maryland, on June 26, 1978. They went through the Chesapeake & Delaware Canal, sailed down Delaware Bay to the Atlantic, and traveled up the East Coast to the Hudson River. Passing up the Hudson to Troy, New York, the yacht then passed through the Erie Canal to Lake Ontario. Sailing along the south shore of the lake, petitioners took the Welland Canal in Canada to Lake Erie, and went south across Lake Erie to Erie, Pennsylvania, arriving on July 5, 1978. Aboard the vessel during this trip were Harry and Pat Myers, their 13-year old son, and Cyndy's sister. Both Robert and Harry Myers belonged to the Southern Shore Yacht Club, where they met in 1974. Harry was not a client of Robert or of George Bagley & Co. They were social friends. Harry was the president of A-1 Foundry Company in Chicago, Illinois, which he owned together with his wife. In order to handle a 44-foot Trojan yacht safely and properly, Robert needed at least two other persons aboard for line handling; while Robert was at the controls, one person would secure the bow line and the other would secure the stern line. This was especially true during the first part of the trip from Maryland to Erie, Pennsylvania, because of the frequent line-handling requirements in transiting the locks in the Erie and Welland Canals, and in berthing for the night. Harry was an experienced boater and could and did help petitioner with the lines.

Prior to 1978, Robert had had a client who owned an iron foundry in Wisconsin and who had expressed interest in acquiring other foundries. During the trip, Robert discussed the possibility of Harry's selling his foundry, which Robert thought might involve a good fee arrangement for him. Harry commented on the possibility of selling the foundry but was not really excited about the sale.

Petitioners and their party left the yacht in Erie, Pennsylvania, on July 5, 1978, for repairs, and went home. A number of mechanical problems with the yacht had occurred on the trip -- the air conditioning broke down, the two electrical alternators burnt out, and the fuel injectors of the diesel engines were not properly set, causing extensive deposits of soot on the yacht. The repairs were made between July 6 and 12, 1978.

On July 13, 1978, Robert picked up the yacht at Erie, Pennsylvania, and sailed it to New Buffalo, Michigan, at the southern end of Lake Michigan, arriving on July 18, 1978. Also on board during this trip were Raymond Grana and George Lebeda. Raymond Grana and petitioner met in 1973 at the Southern Shore

Yacht Club at the Jackson Park Inner Harbor. Grana owned a boat that was moored there. Grana and Robert became friends and saw each other between five and eight times a year; Grana had been to petitioners' house on several occasions. Robert's only purpose for inviting Grana on this trip was to help him handle the lines in order to bring the boat to New Buffalo, Michigan. Grana did not have a business relationship with Robert or with the partnership. George Lebeda was also a long time member of the Southern Shore Yacht Club, where he met Robert and Grana, and also had his boat docked in New Buffalo, Michigan. Lebeda was the owner of Ace Hardware Store in Chicago, Illinois. Lebeda had expressed his desire to sell his business and Robert took advantage of the opportunity to discuss various methods by which Lebeda could sell his business. They left the yacht in New Buffalo, Michigan on July 18, 1978.

On July 23, 1978, petitioners gave a champagne party aboard their yacht for the members of the Lake Michigan Yacht Club in New Buffalo. Robert had been a member of the Lake Michigan Yacht Club since 1974, but had never docked the yacht in New Buffalo before. A champagne party was traditionally given by the owners of a vessel newly moored at the yacht club. The purpose for the party was purely personal, and no business was discussed nor resulted to petitioner as a consequence of the party.

On July 30, 1978, petitioners cleaned the yacht and on July 31, 1978, a diesel mechanic from Cummins came aboard to repair the engine.

On August 6, 1978, petitioners entertained Cyndy's family aboard the vessel. The purpose for this entertainment was purely personal.

Petitioners entertained William Jordan and his fiancée aboard the yacht on August 13, 1978. William Jordan was an attorney and a business associate of Robert. Jordan handled legal matters for some of Robert's clients, and Robert did accounting work for some of Jordan's clients. Jordan called Robert a few days before August 13, 1978, and told him that he would like to discuss Tackberry's businesses. Tackberry, Jordan's client, needed an accountant and Jordan wanted to explore the possibility of Robert's becoming Tackberry's accountant, which Jordan thought was a means to cement his attorney-client relationship with Tackberry. Robert invited Jordan to the yacht, where they discussed Tackberry's businesses. Although Cyndy was also on the yacht, she did not participate in the conversations between Robert and Jordan and stayed with Jordan's fiancée on the lower level of the yacht. Robert took the yacht out to Lake Michigan, where they spent the day.

George Arquilla was the vice president of Burnside Construction Company. George built the townhouse development in which both petitioners and the Arquillas lived, in Palos Heights, Chicago, in 1977. George Arquilla did not have a business relationship with Robert or with George Bagley & Co. in 1978. Arquilla and his wife were invited aboard the yacht and entertained by petitioners on August 20, 1978. George and Robert discussed the state of the economy and of George's company. Robert discussed his experience as an accountant, his association with George Bagley & Co., and the type of clients that they had. This discussion did not last more than a half hour. This was a casual, social discussion, not directly related to any specific business matter. In 1978, Burnside Construction Company had an in-house comptroller and accounting staff. No business for Robert or for George Bagley & Co. resulted from the discussion aboard the vessel on this trip. Robert noted on his log that he and George had "Discussed setting up of home-owners association, Oak Hills construction program & services GB & Co. renders." Petitioners and the Arquillas spent New Year's Eve together in 1978. The Arquillas were invited to and spent the fourth of July weekend aboard the yacht in 1979.

On August 27, 1978, petitioners entertained Mr. and Mrs. Allen Eliot aboard the vessel. Allen Eliot was a partner of George Bagley & Co. Eliot and Robert discussed billing rates, personnel matters, clients, and the future of the partnership from the standpoint of the partners. Eliot had mentioned to petitioner that he was considering retirement and this was also discussed. Eliot and Robert met outside of the partnership's offices since they did not like to discuss personnel matters there because of the numerous interruptions. Neither Cyndy nor Mrs. Eliot participated in the business discussions between Eliot and Robert. The nature of the relationship between Eliot and Robert was strictly business.

On August 28, 1978, petitioners entertained Mr. and Mrs. William Youngquist and Mr. and Mrs. Robert Hutchinson on the yacht. At the time, William Youngquist was a partner in George Bagley & Co.; Robert Hutchinson was his personal friend and client. In 1978, Youngquist allowed Robert to start billing on his clients' accounts. Hutchinson was the president of a water treatment company, H.O.H. Youngquist and Hutchinson were invited on the yacht for the purpose of discussing Hutchinson's business affairs. Hutchinson was contemplating bringing in his son to work for him. The possibility of developing better data processing and of making contributions to H.O.H.'s profit sharing plan were discussed. They also discussed the convenience of a pension plan as compared to the existing profit sharing plan. Hutchinson was not a friend of petitioners. Petitioner did some work for Hutchinson before 1978, and all of his accounting work in 1978. Hutchinson and Youngquist also discussed the possibility of Youngquist's retirement. Neither Cyndy nor Mrs. Youngquist or Mrs. Hutchinson participated in the business discussions, but stayed on another section of the yacht.

Petitioners entertained Robert Drewniak and a Mr. and Mrs. Guerin aboard the yacht on August 29, 1978. Drewniak was the chairman of the board of Apex Railway Products Co. and a client of George Bagley & Co. The Guerins were personal friends of Drewniak and were invited by him. Robert invited Drewniak on the yacht for the purpose of discussing the billing of Apex, since Drewniak had expressed some concern that the bills were too high.

There was also some discussion as to whether a revenue ruling should be requested from the Internal Revenue Service in order to determine whether under the provisions of its pension plan Apex could borrow funds to invest in Treasury Bills.

On September 3, 1978, petitioners entertained Jay M. Smyser and Kathy O'Leary aboard the vessel. Smyser, an attorney, has been a client of Robert since approximately 1969. Kathy O'Leary worked as Smyser's paralegal. Smyser was invited on the yacht to discuss his tax status, certain expenditures that he wanted to incur for promotional purposes, and the termination of his association with Phalen & Pope, a law firm. Robert also wanted to ascertain whether Smyser's business associates would be interested in his services. Although Smyser considered Robert his friend, the relationship between them was essentially of a business nature.

Petitioners entertained John and Georgia Kuranz and their children, ages 2 and 4, aboard the yacht on Labor Day, September 4, 1978. Also present were Mr. and Mrs. J. L. Kuranz, the parents of John Kuranz. In 1978, John Kuranz was the owner of Management Contents. Both John Kuranz and his father J. L. Kuranz were clients of Robert. J. L. Kuranz was also a stockholder of Management Contents. Labor Day was a convenient time for J. L. and John Kuranz and Robert to meet in order to discuss the quarterly financial statements, sales, receivables, and cash requirements of Management Contents. J. L. Kuranz and Robert further discussed matters related to Stark Enterprises, Kuranz's company in Georgia. Georgia Kuranz, Cyndy, Mrs. J.L. Kuranz, and the children were not present during these discussions, which were conducted on the lower level of the yacht, but were at the beach. They did not go out on the yacht.

On September 9 and 10, 1978, petitioners entertained Mr. and Mrs. George Lebeda aboard their vessel. Petitioners and the Lebedas sailed from New Buffalo, Michigan, to Kenosha, Wisconsin, and back to New Buffalo. Robert had been acting as George's money manager. Robert was paid a fee for managing approximately $100,000. George was thinking about withdrawing the money, which petitioner dissuaded him from doing. In addition to this, the Lebedas and Robert discussed the possibility of Robert's doing some estate planning for them, which never materialized. The Lebedas were old friends of Cyndy; their children and Cyndy had attended the same grammar school.

On September 17, 1978, petitioners entertained Raymond and Mary Krysl aboard the yacht. Raymond was an attorney and an accountant, and was a partner in George Bagley & Co. in 1978. Raymond was invited on the yacht in order to discuss personnel matters and the allocation of profits as per the partnership agreement, in view of impending retirement of one of the partners. The yacht afforded them privacy. The nature of the relationship between Raymond and petitioner was strictly business.

On September 18, 1978, mechanics from both Cummins and Onan serviced the engine and the generator of the yacht, respectively. On September 24, 1978, petitioner went to New Buffalo, Michigan, and took the yacht to Rodi's Boat Yard in Chicago, Illinois, for repairs.

Robert entertained William Jordan, Mr. and Mrs. Frank Nichols, and another couple aboard the yacht on September 29, 1978. Frank Nichols was an Englishman who was Jordan's client. Jordan phoned Robert and apprised him that Nichols was in Chicago for two days and was contemplating the possibility of developing distributorships and a boat manufacturing facility in the United States. Since one of the areas that Nichols was concerned about was the tax aspects of the transaction, Jordan wanted to schedule an appointment with Robert for Nichols. Robert stated that the yacht was at Rodi's Boat Yard in Chicago and that he was going to pick it up that afternoon, and suggested that they meet there. Nichols invited two friends of his to come along. They went to Rodi's Boat Yard where they met with Robert. From there they went down the Chicago River to the Chicago Yacht Club, where they had dinner and drinks. On the way to the Chicago Yacht Club, Nichols and Robert discussed Nichols' concerns. Nichols and his friends left after dinner and Jordan and Robert took the yacht back to New Buffalo, Michigan. During the trip to New Buffalo, Michigan, petitioner and Jordan reviewed the earlier discussion between Robert and Nichols. No business for petitioner or for George Bagley & Co. resulted from the discussions held aboard the vessel during this trip.

On October 1, 1978, petitioners entertained Emily Lebeda, George Lebeda's mother, and her daughter aboard the yacht, in New Buffalo. Emily had requested a meeting with petitioner in order to discuss payment of a note given to her by her daughter. Robert talked to Emily about the possibility of redrafting her will. After the discussion, which lasted approximately two hours, petitioners went back to Chicago.

Robert entertained Charles Massaro aboard the vessel on October 21, 1978. Massaro was the comptroller of Wisconsin Can Company and the president of its subsidiary, Rex Filter Corporation. These companies were clients of George Bagley & Co. Massaro was invited on the yacht in order to discuss Rex Filter's audited financial statement as of November 30, 1978. The relationship between Massaro and Robert was of a business nature in 1978.

Petitioner maintained a log on the yacht, listing: (1) The days that the yacht was used; (2) the persons entertained, if any; (3) the purpose for the entertainment; and (4) whether, in his opinion, the reason for inviting the indicated guest on the yacht was business or pleasure. The entries on the log were made at the end of each use of the yacht. The log indicated that the yacht was used 31 days for entertainment in 1978. Petitioner indicated in the log his opinion that 30 of the 31 days, or 96.77

percent of the yacht's use for entertainment, was for business purposes. Robert was not reimbursed by George Bagley & Co. for the expenses incurred for the operation and maintenance of the yacht in 1978.

The yacht was used on 42 calendar days in 1978 -- 19 calendar days of use were for personal or nonbusiness purposes; 11 calendar days of use were for repair or maintenance purposes; and 12 calendar days of use were for business purposes.

Robert's reported distributive share of income from the partnership in 1978 was $57,110. He claimed business expenses in the total amount of $54,012 -- of which total $47,611 were attributable to the yacht -- for a total net income from the partnership of $3,098 in 1978.

Petitioners' claimed items of expense and credit in connection with the operation and maintenance of the yacht were as follows:

Fuel	$ 2,027
Insurance	1,655
Repairs & Maintenance	1,239
Supplies	770
Moorings	1,565
Storage	221
Yacht Club Dues, Etc.	401
Interest Expense - Boat	8,465
Depreciation Expense	32,857[1]
Maintenance and Operating Expenses	$49,200
Less: Personal Portion (3.23%)	(1,589)[2]
Total Claimed Business Expenses	$47,611 [3]

Petitioners also claimed an investment tax credit with respect to the purchase of the yacht in the amount of $14,349.35 in 1978.[4]

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[1] Petitioners claimed a depreciable basis in the yacht of $148,283, and used the double declining balance method of depreciation over a 10-year useful life. Petitioners further claimed additional first year depreciation in the amount of $4,000.

[2] According to the log, the yacht was used on 31 days in 1978, and 30 of those 31 days, or 96.77 percent of the yacht's use, was for business purposes. Petitioners therefore deducted 3.23 percent, the portion allegedly attributable to their personal use of the yacht, from the total maintenance and operating, and depreciation expenses in order to arrive at the net claimed amount.

[3] Petitioners also claimed an interest expense deduction attributable to their personal use of the yacht in the amount of $273 (3.23 percent of $8,465) on Schedule A attached to their 1978 return.

[4] Calculated as follows:

Claimed Qualified Investment in the Boat	$148,283.00
Multiplied by:	X .10
Total Investment Tax Credit	$ 14,828.30
Less: Personal Use (3.23 percent)	(478.95)
Claimed Investment Tax Credit	$ 14,349.35

Petitioners filed Form 1045, Application for Tentative Refund, on March 6, 1979. Because their return showed zero Federal income tax due for 1978, the unused claimed investment tax credit in connection with the purchase of the yacht was carried back to petitioners' taxable years 1975, 1976, and 1977.

In his notice of deficiency, respondent disallowed a portion of the claimed maintenance and operating expenses, depreciation expense, and investment tax credit with the following explanations:

> Out of Pocket Expense - Boat
>
> The deduction of $7,623.00[5] shown on your 1978 return as boat maintenance and operating expense is reduced by $3,736, because it has not been established that more than $3,887.00 was for an ordinary and necessary business expense. The $3,736 is also unallowable because it is lavish and extravagant pursuant to Internal Revenue Code Section 274 and the Regulations thereunder. Accordingly, your taxable income for the year 1978, is increased $3,736.00.
>
> Depreciation Expense - Boat
>
> The deduction of $31,796.00[6] shown on your 1978 return as boat depreciation is reduced by $29,515.00 because that amount is lavish and extravagant within

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[5] Respondent arrived at this amount by taking the gross amount of maintenance and operating expenses, exclusive of interest and depreciation, ($7,878) and reducing the said amount by the portion of the said expenses allegedly attributable to petitioners' personal use of the yacht (3.23 percent). The computation is as follows: $7,878 - ($7,878 X .0323) = $7,623 (rounded to the nearest dollar amount).

[6] Respondent arrived at this amount by taking the depreciation allowance calculated by petitioners ($32,857, see n. 1) and reducing this amount by the portion allegedly attributable to petitioners' personal use of the yacht (3.23 percent). The calculation is as follows; $32,857 - ($32,857 X .0323) = $31,796 (rounded to the nearest dollar amount).

the meaning of Internal Revenue Code Section 274 and the Regulations thereunder. Therefore, your taxable income, for the year 1978, is increased $29,515.00.

Investment Tax Credit

The $14,349[7] shown as an investment credit in 1978 on a Trojan 44 Ft. yacht is disallowed because the property does not qualify for the investment tax credit under Section 48 of the Internal Revenue Code. Therefore, your tax is increased in the years in which the credit was applied as follows:

Credit carried back to 1975	$4,215.00
Credit carried back to 1976	3,221.00
Credit carried back to 1977	5,179.00

OPINION

Issue 1. Business Expenses and

Issue 2. Depreciation

Section 162(a)[8] allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. As used in section 162(a), "ordinary" has been defined as that which is "normal, usual, or customary" in the taxpayer's trade or business. Deputy v. duPont, 308 U.S. 488 (1940); Boser v. Commissioner, 77 T.C. 1124 (1981), affd. in an unpublished opinion (9th Cir. 1983). The Supreme Court stated in Welch v. Helvering, 290 U.S. 111, 113 (1933), that "necessary", as used in the predecessor of section

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[7] See n. 4, supra.

[8] All statutory references are to the Internal Revenue Code of 1954, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

162(a), means "appropriate and helpful" for the development of taxpayer's business. Whether an expenditure is ordinary and necessary is a factual determination. *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Voight v. Commissioner*, 74 T.C. 82 (1980).

Section 167(a)(1) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business. Sec. 1.167(a)-1, Income Tax Regs.

Section 262 provides that no deduction will be allowed for personal, living, or family expenses. Section 262 takes precedence over sections 162 and 167.[9] Business expense deductions, including depreciation, for items with respect to a facility used in connection with entertainment which are otherwise allowable under sections 162(a) and 167(a)(1) are not to be allowed unless the provisions of section 274 are also met. Sec. 1.274-1, Income Tax Regs.

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[9] Secs. 162 and 167 fall within part VI of subchapter B, and section 262 falls within part IX of subchapter B of chapter 1 of the Code. Sec. 161 provides that "there shall be allowed as deductions the items specified in this part [part VI], subject to the exceptions provided in part IX." Sec. 262, falling within part IX of subchapter B, thus carves out exceptions to what might otherwise be deductible expenses under secs. 162 and 167. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974); *Sharon v. Commissioner*, 66 T.C. 515 (1976), affd. per curiam 591 F.2d 1273 (9th Cir. 1978), cert. denied 442 U.S. 941 (1979).

Section 274(a)(1)(B)[10] provides in part that no deduction otherwise allowable shall be allowed with respect to an entertainment facility unless: (1) The facility was used primarily for the furtherance of taxpayer's trade or business; and (2) the expenditure was directly related to the active conduct of the trade or business.[11] Furthermore, the deduction cannot exceed the portion of such expenditure directly related to the active conduct of taxpayer's trade or business. Sec. 274(a)(1). If deductions are disallowed under section 274(a) with respect to any portion of a facility, such portion is treated as an asset which is used for personal, living, and family purposes, and not as an asset used in the trade or business. Secs. 274(g), 1.274-7, Income Tax Regs.

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[10] Sec. 274(a)(1)(B) was amended by sec. 361(a) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2847. The amendment, applicable to items paid or incurred after December 31, 1978, in taxable years ending after such date, disallows deductions with respect to facilities used in connection with entertainment, amusement, or recreational activities.

[11] Sec. 274(a)(1) provided as follows in 1978:

> (a) Entertainment, Amusement, or Recreation.--
>
> (1) In General.--No deduction otherwise allowable under this chapter shall be allowed for any item--
>
> (A) Activity.--With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or
>
> (B) Facility.--With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

(footnote continued)

In his statutory notice of deficiency herein, respondent allowed a portion of the claimed yacht expenses and depreciation,[12] apparently based upon his allocation between business and nonbusiness use. Implicit in this determination was respondent's acknowledgement that petitioners had satisfied the "primary use" test of section 274(a)(1)(B); otherwise all of the claimed depreciation and deductions, other than interest, would have been disallowed. The pleadings were consistent with this analysis of the issues presented.

(footnote continued from previous page)

> and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

[12] The claimed interest expense was allowed in full. See secs. 1.274-2(e)(3)(iii)(c), 1.274-6, Income Tax Regs.

Both at trial and on brief, however, the parties argued and briefed, inter alia, the "primary use" issue, without objection from either side. Since the resolution of this issue has the potential effect of broadening the disallowance of petitioners' claimed deductions, we treat it as a new issue not raised by the pleadings, but tried with the consent of the parties. Rule 41(b)(1). As to the new matter outside the statutory notice of deficiency -- petitioners' entitlement to the claimed yacht expenses and depreciation allowed by respondent, in the respective amounts of $3,887 and $2,281 -- the burden of proof is on respondent. Rule 142(a).

In order to satisfy the "primary use" requirement of section 274(a)(1)(B), it must be established that, considering all the facts and circumstances, the primary use of the facility was for purposes considered ordinary and necessary. Petitioners argue that they satisfy the safe harbor test provided in section 1.274-2(e)(4)(iii), Income Tax Regs. Under this provision, an entertainment facility is considered as used primarily for the furtherance of taxpayer's trade or business if it is established that more than 50 percent of the total calendar days of use of the facility during the taxable year were of business use. A facility is deemed to have been primarily used for such purposes on any calendar day if the facility was used for the conduct of a substantial and bona fide business discussion notwithstanding that the facility may also have been used on the same day for personal or family use by the taxpayer or any member of the taxpayer's family not involving entertainment of others by, or under the authority of the taxpayer. Sec. 1.274-2(e)(4)(iii), Income Tax Regs.

A facts and circumstances test is to be applied in determining whether any discussion constitutes a substantial and bona fide business discussion. Sec. 1.274-2(d)(3)(i)(a), Income Tax Regs. It must be established, however, that: (a) The taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining income or other specific trade or business benefit; and (b) such business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment, viz, that the principal character or aspect of the combined entertainment and business activity was the active conduct of business. Sec. 1.274-2(d)(3)(i)(a), Income Tax Regs.

In order to satisfy the "directly related" requirement of section 274(a)(1)(B), it must be established that: (a) The taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit at some indefinite future time from the occasion; (b) the taxpayer actively engaged in a business discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit; (c) the principal character or aspect of the activity was the active conduct of taxpayer's trade or business. "The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on * * * yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary." Sec. 1.274-2(c)(3)(iii), Income Tax Regs.; Davidson v. Commissioner, 82 T.C. 434 (1984); and (d) the expenditure is allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment. Secs. 1.274-2(c)(3)(i) -- (iv), Income Tax Regs.

An expenditure is also considered to be directly related to the active conduct of taxpayer's trade or business if it is established that the entertainment occurred in a clear business setting. Secs. 1.274-2(c)(2) and (4), Income Tax Regs.

Section 274(d) provides in part that an otherwise deductible entertainment expenditure is not deductible unless the taxpayer substantiates by adequate records or sufficient evidence corroborating his own statement the: (1) Amount of the expenditure; (2) time of entertainment; (3) place of entertainment; (4) business purpose of entertainment; and (5) business relationship of persons entertained. See sec. 1.274-5(b)(3), Income Tax Regs.

An "adequate record" is defined in part as an entry in an account book, diary, or similar record made at or near the time of the expenditure. Sec. 1.274-5(c)(2)(ii), Income Tax Regs. As to each expenditure element not substantiated by adequate records, the substantiation requirements may be satisfied by "sufficient evidence," defined in part as: (1) The taxpayer's own statement, whether written or oral, containing specific information in detail as to such element; and (2) other corroborative evidence sufficient to establish such element. Sec. 1.274-5(c)(3), Income Tax Regs. If such element is the business relationship to the taxpayer or business purpose of an expenditure, the corroborative evidence may be circumstantial. Sec. 1.274-5(c)(3), Income Tax Regs.

Facilities which might be used for, or in connection with entertainment include yachts. Sec. 1.274-2(e)(2)(i), Income Tax Regs. Expenditures with respect to a facility used in connection with entertainment include depreciation, operating costs, and expenses for the maintenance, preservation, or protection of the facility. Sec. 1.274-2(e)(3)(i), Income Tax Regs.

There is no question that petitioners' yacht constituted an entertainment facility and that the expenses claimed by petitioners with respect to the yacht constitute expenditures with respect to an entertainment facility. See secs. 1.274-2(b)(1)(i), 1.274-2(e)(2)(i), 1.274-2(e)(3)(i), Income Tax Regs. Therefore, for the claimed yacht expenses and depreciation to be allowable it must be established that: (1) The claimed yacht expenses and depreciation were ordinary; (2) the claimed expenses were necessary for the development of Robert's accounting business; (3) the yacht was used primarily for the furtherance of Robert's trade or business; and (4) the claimed yacht expenses and depreciation were directly related to the active conduct of Robert's trade or business. Secs. 162(a), 274(a)(1)(B); secs. 1.274-2(a)(2); 1.274-2(c)(1), (2), and (3); 1.274-2(d)(3)(i)(a), Income Tax Regs. It must be clearly established that the active conduct of trade or business was the principal character or aspect of the activity on the yacht. Sec. 1.274-2(c)(3)(iii), Income Tax Regs. Finally, the prescribed elements with respect to the claimed expenditures -- amount, time, place, business relationship, and business purpose -- must be adequately substantiated. Sec. 274(d); sec. 1.274-5, Income Tax Regs.

The amount of the claimed maintenance and operating expenses, and the fact that the said amounts were expended are not in issue here. (The basis of the yacht for depreciation purposes is in issue.) Petitioners have conceded, on brief, that they are not entitled to deduct maintenance and operating expenses and depreciation in connection with their use of the yacht: (1) On July 23, 1978, when they hosted a champagne party for the members of the Lake Michigan Yacht Club; and (2) on August 6, 1978, when they entertained Cyndy's family. Respondent has conceded on brief that the log maintained by Robert substantiates the time and place of the expenditures.

While some portion of the claimed expenses and credit sprang from purely social or personal motives, there is evidence in the record to establish that petitioners actually made some use of the yacht which was related to Robert's trade or business.

Petitioners acquired the yacht in 1978, and as we have found, it was used on 42 calendar days in 1978.[13] The first use of the yacht was a 10-day cruise -- from June 26, 1978 to July 5, 1978 -- from Elkton, Maryland, to Erie, Pennsylvania. The ultimate goal of petitioners was to transport the yacht to New Buffalo, Michigan. Petitioners invited Harry and Pat Myers, and Cyndy's sister, to come along. The Myers brought their 13-year old son with them. Harry was an experienced boater and was not a client of Robert or of George Bagley & Co. As Robert testified, in order to handle the yacht -- a 44-foot yacht -- safely and properly, Robert needed at least two other persons aboard for line handling, one at the bow and the other one at the stern, while he operated the controls.[14] Cyndy did not have any boating experience prior to her marriage to Robert, and her role on the yacht was only that of hostess. Cyndy's sister was invited, according to Robert because he "needed extra hands;" the record herein is devoid, however, of any evidence that Cyndy's sister had any boating experience or that she could help or did help in handling the lines.

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[13] Days of use of the yacht for repair or maintenance purposes and of dockside use are to be included in the total calendar days of use. *Davidson v. Commissioner*, 82 T.C. 434, 442-443 (1984).

[14] Petitioner testified as follows:

> Q: I will ask you one question, Mr. Wott and you will understand that I happen to be a boating person myself --
>
> A: I didn't realize that sir.
>
> Q: -- so I have some appreciation of the problem. Would you agree with me that a 44 foot Trojan, to handle safely and properly, you would require *at least two other people to be aboard with you for line handling*.
>
> A: That is correct, sir.
>
> Q: So if you hadn't asked Mr. Lebeda or Mr. Myers, you needed two other people really to handle that boat and particularly as you pointed out in the Welland Canal, you probably needed more than that.

(footnote continued)

While Robert did have discussions with Harry concerning the possible sale of his foundry, we think that the said discussions were not substantial and bona fide. In this regard, we note that Robert's testimony that Harry had mentioned his desire to sell his foundry prior to the cruise was contradicted by Harry, who testified that it was Robert who had approached him and stated that a client of his, who had an iron foundry in Wisconsin, was

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(footnote continued from previous page)

> A: Right. There were two people from the standpoint of whenever you go through a lock, on the Lebeda, Grana, trip --
>
> Q: Or whenever you come along side?
>
> A: Yes. But however on the Lebeda, Grana trip, the two people; I mean George Lebeda did not really actively get involved in helping.
>
> Q: Well, I understand. But [the] thrust of my question, I hope you agree with me, is that regardless of whether you discussed business or not, you needed two; really needed two able bodied persons to help you handle the boat properly.
>
> A: Generally that will be correct, yes. Especially during the first part of the trip, Your Honor. [Emphasis added.]

interested in acquiring a foundry in Mount Ferris. In fact, the business relationship between Robert and his unidentified client had terminated prior to 1978.

We are also satisfied that Robert had no more than a general expectation of deriving some income or trade or business benefit at some indefinite future time from the discussion. The principal character of the trip was not the active conduct of Robert's trade or business, but a personal one. See secs. 1.274-2(c)(3)(i) -- (iv), Income Tax Regs.

The yacht remained in Erie, Pennsylvania, from July 6 to 12, 1978, for repairs.[15]

The requirements of section 274 have also not been satisfied with respect to the trip from Erie, Pennsylvania, to New Buffalo, Michigan, on July 13 to 18, 1978. Admittedly, Robert's purpose for this trip was purely a personal one, to transport the yacht to its new home port. Aboard the yacht with Robert on this trip were Grana and George Lebeda. It is undisputed that Grana was an experienced boater and Robert's friend, and that he was invited by petitioner for the exclusive purpose of helping him with handling the lines. George Lebeda was similarly an experienced boater and met petitioner at the Southern Shore Yacht Club. As we have found, Robert and George Lebeda discussed various methods by which Lebeda could sell his business. We are, however, satisfied that the conversations were incidental and not substantial in relation to the entertainment. The presumption that the active conduct of trade or business is considered not to be the principal character of the combined business and entertainment activity on the yacht, rebuttable by clearly establishing to the contrary, has not been rebutted. Lebeda did not testify at the trial herein. Grana testified as follows:

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[15] See n. 13, *supra*.

> Q: Do you -- were you privey [sic] or did you overhear or were aware of any conversations between Mr. Lebeda and Mr. Wott?
>
> A: Yes, I did on several occasions come up from down below and we did a lot of driving from the bridge, and they were like engaged in a conversation and I would come in and would catch parts of it and all that.
>
> Q: I see. So there was some conversation. Do you recall any specifics with regard to this conversation? Do you remember the nature of the business?
>
> A: Well, George was in the process of deciding to get out of the hardware business and I think that him and Bob were talking about price or whatever. [Emphasis added.]

Finally, petitioners argue that the "directly related" test of section 274(a)(1)(B) has been satisfied with respect to the foregoing uses of the yacht -- June 26, 1978 to July 5, 1978, and July 13, 1978 and July 18, 1978 -- in that the yacht was a "clear business setting" within the meaning of section 1.274-2(c)(4), Income Tax Regs. We disagree. Section 1.274-2(c)(4), Income Tax Regs., provides that entertainment shall not be considered to have occurred in a clear business setting unless it is clearly established that "any recipient of the entertainment would have reasonably known that the taxpayer had no significant motive in incurring the expenditure, other than directly furthering his trade or business."

It is clear from the record herein that Robert's invitation to Harry and Pat Myers was not couched in terms of a business meeting.[16] Harry was not a client of Robert or of the partnership. The Myers brought along their 13-year old son. While petitioner testified that when he invited Harry Lebeda he made it clear that the purpose of the trip was to discuss the sale of his business, his testimony was not supported by any other evidence. George was not a client of Robert or of the partnership prior to the trip. Furthermore, the members of the Lebeda family were Cyndy's friends. We find, and so hold, that neither the Myers nor George knew that Robert had no significant motive, other than directly furthering his trade or business in inviting them on the trip. These are also not situations where there was no meaningful personal or social relationship between petitioners and the recipients of the entertainment. See sec. 1.274-2(c)(4), Income Tax Regs. Cf. sec. 1.274-2(c)(3)(iii), Income Tax Regs.

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[16] Harry testified as follows:

> Q: How did the invitation to go on that cruise arise?
>
> A: Well he [Robert] asked me and my wife if we would like to make the trip. He was picking up the boat and my wife is also half owner of my company, of course.
>
> Q: Yes.
>
> A: And it just worked out that I took my wife and my son, and I think he was about 13 at the time --
>
> Q: Your son was about 13 years of age?
>
> A: Yes. And the three of us went on a trip with him.
>
> Q: Yes.
>
> A: And I have had boating experience, so that worked out fairly well too. [Emphasis added.]

The requirements of sections 274(a) and 274(d), and the regulations thereunder[17] have been satisfied with respect to the entertainment of: (1) William Jordan and his fiancèe on August 13, 1978; (2) Mr. and Mrs. Allen Eliot on August 27, 1978; (3) Mr. and Mrs. William Youngquist and Mr. and Mrs. Robert Hutchinson on August 28, 1978; (4) Robert Drewniak and Mr. and Mrs. Guerin on August 29, 1978; (5) Jay M. Smyser and Kathy O'Leary on September 3, 1978; (6) John and Georgia Kuranz and Mr. and Mrs. J. L. Kuranz on September 4, 1978; (7) Mr. and Mrs. George Lebeda on September 9 and 10, 1978; (8) Raymond and Mary Krysl on September 17, 1978; (9) William Jordan and Mr. and Mrs.

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[17] Congress granted respondent plenary authority to promulgate the necessary regulations to implement the purposes of sec. 274, not only under the general rule-making power granted in sec. 7805, but also under the mandate of sec. 274(i). The regulations have been found to reflect a reasonable interpretation of the statute on numerous occasions. See Andress v. Commissioner, 51 T.C. 823 (1969), affd. 423 F.2d 679 (5th Cir. 1970); Sanford v. Commissioner, 50 T.C. 863 (1968), affd. per curiam 412 F.2d 201 (2d Cir. 1969), cert. denied 396 U.S. 841 (1969); Ashby v. Commissioner, 50 T.C. 409 (1968); Robinson v. Commissioner, 51 T.C. 520 (1968).

Frank Nichols, and another couple on September 29, 1978; Emily Lebeda and her daughter on October 1, 1978; and (11) Charles Massaro on October 21, 1978.

With respect to the foregoing 12 days of entertainment use of the yacht, the parties are in agreement as to the first element of substantiation -- amount of the expenditures; the second and third elements of substantiation -- time and place -- have been established by the log kept by Robert, as conceded by respondent. Of the remaining two elements -- business purpose and business relationship -- the business purpose has been established to our satisfaction by Robert's log, petitioners' testimony, the testimony of the witnesses,[18] petitioners' exhibits, and circumstantial evidence. Although George and Emily Lebeda and Robert Drewniak did not testify, we are satisfied that the last substantiation requirement, business relationship, was satisfied, for the aforesaid days, by Robert's log, petitioners' testimony, and by circumstantial evidence.

It has also been established that during the foregoing 12 days of use, the yacht was used for the conduct of substantial and bona fide business discussions, viz, that the yacht was used for the furtherance of Robert's business; and that the expenditures allocable to the said 12 days of use were directly related to Robert's business, since the requirements of section 1.274-2(c)(3)(i) -- (iv), Income Tax Regs., have been satisfied.

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[18] William Jordan, Allen Eliot, William Youngquist, Robert Hutchinson, Jay M. Smyser, John Kuranz, Raymond Krysl, and Charles Massaro appeared, inter alia, as witnesses at the trial herein.

The requirements of section 274(a)(1)(B) and the regulations thereunder were not satisfied with respect to the entertainment use of the yacht on August 20, 1978, when petitioners invited George Arquilla and his wife aboard the yacht. The Arquillas were petitioners' neighbors in 1978. They were not clients of Robert or of the partnership, and considered petitioners' invitation a "neighborly act." Petitioners and the Arquillas went from the Chicago Yacht Harbor to New Buffalo, Michigan. Petitioners and the Arquillas discussed the contracting business, the state of the economy and of George's company's affairs, and Robert's clients and his past association with the partnership. The formation of a home-owners association at petitioners' and the Arquillas' neighborhood was also discussed. As George testified, this discussion was not directly related to any specific business matter and did not last more than a half hour. The Arquillas were again invited aboard the yacht for the Chicago Yacht Club annual cruise in July 1980. Although there was some confusion in George Arquilla's mind as to whether the above-mentioned discussion with petitioners had taken place in 1978 or 1980, we find it relevant that: (1) Arquilla testified that on one of the two occasions there was no business discussion and that he considered it a social occasion; (2) Arquilla did not consider the activity a business one. No income resulted to petitioner or to the partnership from this discussion. We are satisfied that regardless of whether the foregoing discussion between petitioners and the Arquillas occurred in 1978, the said discussion was incidental to the entertainment, and not a substantial and bona fide discussion.

It has also not been established that the expenditures allocable to this use of the yacht were directly related to the active conduct of Robert's trade or business within the meaning of sections 1.274-2(c)(3) or (4), Income Tax Regs. It has not been established that Robert had more than a general expectation of deriving some income or some specific business benefit from the activity. Sec. 1.274-2(c)(3)(i) and (ii), Income Tax Regs. Nor has it been clearly established that the active conduct of business was the principal character of the activity. Sec. 1.274-2(c)(3)(iii), Income Tax Regs. The yacht was not a clear business setting as contended by petitioners. Arquilla's testimony that he considered petitioner's invitation a "neighborly act" is inconsistent with a finding that the Arquillas would have reasonably known that petitioner had no significant motive, in incurring the expenditure, other than directly furthering his business. See sec. 1.274-2(c)(4), Income Tax Regs.

As we have found, the 11 calendar days of repair or maintenance use are included in the total calendar days of use. The apportionment contemplated by section 274 is achieved by allocating the calendar days of repair or maintenance use between the business and the nonbusiness categories in the same proportion as the otherwise determined calendar days of business and nonbusiness use in determining whether the yacht was used primarily for the furtherance of Robert's trade or business. Davidson v. Commissioner, supra. Since, for 1978, less than 50 percent of the total calendar days of use of the yacht were days of business use, petitioners' use of the yacht does not satisfy the test of section 1.274-2(e)(4)(iii), Income Tax Regs. Apportionment of the calendar days of repair and maintenance use does not change the ratio of business use to nonbusiness use. The nonbusiness use was greater than the business use.

Respondent has carried his burden of proof to show that the primary use of the yacht was not a business use, even under the general requirements of section 1.274-2(e)(4)(i), Income Tax Regs. In determining whether business use of a facility exceeds personal use, all of the facts and circumstances are to be considered. Some of the factors to be considered are: (1) The nature of each use; (2) the frequency and duration of use for business purposes as compared to other purposes; and (3) the amount of expenditures incurred during such use for business as compared with the amount of expenditures incurred during use for other purposes. Although petitioner's only motivation in acquiring the yacht and inviting guests on the yacht (but for the two occasions conceded on brief) was to generate business, if his self-serving testimony is to be believed in full, we are satisfied that petitioner derived personal pleasure from owning and operating his yacht. As demonstrated by our analysis, supra, the personal, nonbusiness uses of the yacht and the expenditures connected therewith exceed the business uses of the yacht and the expenditures connected therewith.

As we have also found, supra, the requirement that the expenditures were directly related to the active conduct of petitioner's business was also not satisfied with respect to most of the uses of the yacht.

Since the requirements of section 274(a)(1)(B) are expressed in the conjunctive and not in the disjunctive, both requirements must be satisfied in order for any expenditures to be deductible and then only to the extent of the portion of such expenditures which are directly related to the active conduct of the taxpayers' trade or business. This is consistent with the purpose of section 274, to "prevent tax abuses involving luxury facilities for entertainment, amusement, or recreational purposes." H. Rept. 87-1447, at 22 (1962), 1962-3 C.B. at 426; S. Rept. 87-1881, at 32 (1962), 1962-3 C.B. at 738.[19]

Respondent has satisfied his burden of proof with respect to the amounts originally allowed in his notice of deficiency. Rule 142(a). Petitioners have failed to carry their burden with respect to the amounts disallowed in the notice of deficiency. It follows that petitioners are not entitled to any of the claimed items of expense, including depreciation, other than the claimed interest expense, allowed by respondent. In view of our decision with respect to these issues, we need not address the parties' other contentions.

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[19] Sec. 4 of the Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960, 974, enacted sec. 274.

Issue 3: Investment Tax Credit

Petitioners claimed, and respondent disallowed[20] an investment tax credit in the amount of $14,349.35 in connection with the purchase of the yacht in 1978. Petitioners filed Form 1045, Application for Tentative Refund, for the carry back of unused investment tax credit from 1978 to the years 1975, 1976, and 1977.

Petitioners conceded on brief that the requirements of sections 162 and 274 must be satisfied for the claimed investment tax credit and its carry back to their taxable years 1975, 1976, or 1977 to be allowed. See secs. 162(a), 167, 38, and 274(a)(1)(B); sec. 1.48-1(b)(2), Income Tax Regs.; Dowell v. United States, 522 F.2d 708 (5th Cir. 1975); Davidson v. Commissioner, 82 T.C. at 438. Since we have determined that the requirements of section 274(a)(1)(B) and the regulations thereunder have not been satisfied, it follows that petitioners are not entitled to any investment tax credit, as determined by respondent in his statutory notice of deficiency.

To reflect the foregoing,

Decision will be entered
for the respondent.

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[20] Respondent's disallowance of the claimed investment tax credit in the amount of $14,349.35, in his notice of deficiency is inconsistent with his allowance of a portion of the claimed depreciation expense. See sec. 1.48-1(b)(2), Income Tax Regs.

JU11.7/2:1986-320

COMPLETED

MF 204

T. C. Memo. 1986-320

UNITED STATES TAX COURT

BURTON R. PITTLER and ELIN PITTLER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12457-84. Filed July 28, 1986.

John P. Kelly, for the petitioners.

John O. Kent, for the respondent.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies in petitioners' Federal income taxes of $7,630 in 1975 and $726 in 1976. After a concession by petitioners, the sole issue for decision[1] is whether the partnership Royal Kuhio XI engaged in bona fide transactions during the years in issue, which would give rise to deductible losses by petitioners as limited partners in the partnership.

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[1] Although they pleaded the bar of the statute of limitations in their petition, petitioners stipulated at the time of trial that the assessment of any income tax due for the years in issue is not barred. We take judicial notice of our own records showing that petitioners' counsel routinely pleads limitations when he has no factual support for that claim. See, e.g., Chao v. Commissioner, T.C. Memo. 1985-444; Rosebrough v. Commissioner, T.C. Memo. 1985-339.

Other allegations in the petition were totally unsupported by evidence, and petitioners did not testify or otherwise present any witnesses during trial. Petitioners' counsel failed to appear when this case and related cases were recalled for the submission of certain exhibits that were not attached to the stipulation filed at the time of trial. The Court, therefore, at the time of recall, suggested that the parties' briefs address the propriety of damages under sec. 6673, I.R.C. 1954, as amended. In his opening brief, respondent argued that such damages should be awarded.

Petitioners failed to file a reply brief ordered by the Court, and their opening brief was totally inadequate. See Chao v. Commissioner, supra, Lui v. Commissioner, T.C. Memo. 1985-374, and cases cited therein, wherein petitioners' counsel, representing taxpayers in other tax shelter arrangements promoted by Joseph Laird, experienced the actual imposition and warning of the imposition of damages where he persisted in presenting legally stale and factually groundless claims. Because the exact factual situation existing in this case has not previously been ruled on, we resist the strong impulse to award damages. See Brown v. Commissioner, 85 T.C. 968, 1001-1004 (1985). We note, however, that under our new Rule 33(b), Tax Court Rules of

(footnote continued)

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners were husband and wife and resided in Tarzana, California, at the time they filed their petition herein. Petitioners timely filed 1975 and 1976 joint Federal income tax returns with the Internal Revenue Service Center at Fresno, California.

During the years in issue, petitioners were limited partners in a partnership, Royal Kuhio XI (RK-11). RK-11 was 1 of 49 real estate tax shelter partnerships promoted and sold by the Cal-Am Corporation in 1975. In 1975 and 1976, RK-11 purported to conduct certain real estate transactions for which it reported on its partnership returns for those years expenses in excess of income. Petitioners claimed deductions for their distributive share of the partnership losses on their 1975 and 1976 tax returns. The deductions were disallowed by respondent.

Related Entities

The following entities were associated with the RK-11 transactions in issue:

(footnote continued from previous page)
Practice and Procedure, effective July 1, 1986, we have available in the future additional sanctions against counsel who signs a pleading that he knows is not well founded in fact and warranted in law and/or that is interposed to cause delay.

Cal-Am Corporation	(Cal-Am)
Legal Mortgage Corporation	(LMC)
Bio-Science Resources, Inc.	(BIO)
Go Publishing Company, Inc.	(GO)
Joseph R. Laird, A Professional Corporation	(Laird Inc.)
Kenneth J. Fisher, Inc.	(Fisher Inc.)

At all times relevant here, attorney Joseph R. Laird (Laird) was the president and Kenneth J. Fisher (Fisher) was the secretary, treasurer, and/or vice president of Cal-Am, LMC, BIO, and GO. Another officer of Cal-Am was Kenneth A. Yates (Yates). Laird was president of Laird Inc., and Fisher was president of Fisher Inc.

Formation of RK-11

In 1975, under the direction and control of Laird and Fisher, Cal-Am distributed to select individuals Private Offering Memorandums to promote 49 real estate limited partnerships. The primary objective of the promotion was to encourage those individuals to invest in a limited partnership that would produce tax deductions primarily for interest. Petitioners received and read such a memorandum regarding RK-11.

The RK-11 memorandum was dated November 1, 1975, and contained the following introductory statement:

> The Partnership will be formed for the purpose of acquiring condominium units and a parcel of undeveloped real property. The partnership will be financed from capital contributions made by limited partners, an option to purchase payment made by Legal Mortgage Corporation and a nonrecourse loan by K. J. Fisher, Inc. The purchase of both the condominium units and the land will involve one year's prepayment of interest. In addition to the interest, 20 points will

> be paid to the seller of the condominiums in consideration of acceptance of a purchase money note providing for interest at 7 1/2% per annum and requiring installment payments over a period of 35 years. For the land, 25 points will be paid to the seller in consideration of a purchase money note providing for interest at 5.4% per annum and requiring installment payments over a period of 35 years.
>
> Following purchase, an option to purchase both the condominium units and the land parcel will be granted to Legal Mortgage Corporation in consideration of an option deposit (See: "Option to Purchase" - Page 4).
>
> In addition to the prepaid interest and loan points, the partnership will make payments for legal and set-up management for 1975 post-organizational services.
>
> It is expected that the partnership will operate at a loss for an indeterminate period. The partnership expenses during this period are to be paid from partnership receipts and additional nonrecourse loans from K. J. Fisher, Inc. or from funds of the General Partner.
>
> The partners are required to make a loan to GO Publishing Company, Inc. of an amount equal to their capital contribution to the partnership. The loans by the partners to GO will be in each case evidenced by a note secured by a deed of trust. The note will provide for interest at 6% per annum accruing from January 1, 1976.
>
> GO will sell the condominium units to the partnership. BIO will sell the land parcels to the partnership. Legal Mortgage Corporation will have the option to purchase the partnership properties. Fisher, Inc. will make the initial nonrecourse loan and will be required to make further nonrecourse loans if and when necessary to carry out the partnership business. Laird, Inc. will receive a legal fee for post-organizational services.
>
> All of the above referred to corporations have a common control through Fisher and Laird.

The partnership's investment policy was described in the memorandum as follows: "To create a sound real estate investment. To realize tax losses through deductions currently allowable under the Internal Revenue Code." A schedule in the memorandum included the following information:

TAX WRITE-OFF:

	1975	1976	1977 - 1980
Loan	$152,100	$ -0-	$ -0-
Interest (A.I.T.D.)	45,675	-0-	39,150
Interest (N.R.L.)	-0-	18,073	18,073
Operating Expense		2,100	6,300
Legal & Set-Up Management	12,960	2,000	2,000
Depreciation		6,400	6,400
Write-Off	$210,735	$28,573	$71,923

Partners Total Contributions (Capital and Loans to GO) = $60,000
Write-Off per $1,000 (Total Contributions) $3,512
Write-Off % 351%
Partners Total Capital Contributions = 30,000
Write-Off per $1,000 (Capital Contributions) 7,024
Write-Off % 702%

Petitioners also received an Offeree Questionnaire, a Subscription Agreement, and a copy of the RK-11 Partnership Agreement. The Private Offering Memorandum and the Partnership Agreement described the condominiums to be purchased as follows:

Royal Kuhio - Honolulu, Hawaii
Specific Units - 1307, 1309, 1310

Petitioners completed the Offeree Questionnaire, which required personal and financial information, and on December 30, 1975, they executed the Subscription Agreement to become limited partners in RK-11. In that agreement, petitioners represented that, among other things, they received the Private Offering

Memorandum and they accepted and adopted the Partnership Agreement. The signature page of the Subscription Agreement contained the following notations in bold type:

> The [condominium] units have not been registered under the Securities Act of 1933. Transfer or other disposition of the units is restricted and may not be made without an appropriate opinion of counsel.
>
> The condominium units will not be ready for occupancy until August, 1976.

By letter dated December 30, 1975, Laird, as president of Cal-Am, notified petitioners that they were accepted as subscribers to RK-11 and that their $6,000 contribution had been received. That payment, however, was in the form of a cashiers check to the order of Cal-Am and dated December 31, 1975. Also on December 30, similar letters were written to other investors in RK-11.

On December 31, 1975, Certificates of Limited Partnership were filed for most of the 49 partnerships, including RK-11, with the Recorder's office for the County of Los Angeles, California. The Certificate for RK-11 identified one general partner, Cal-Am, with a $600 contribution and one limited partner, Brian J. Ginsburg, M.D., with a $3,000 contribution. An Amendment of Certificate of Limited Partnership was filed for RK-11 on January 20, 1976. The Amendment identified an additional general partner, Fisher, with no contribution, and 13 limited partners, including petitioners, with total contributions of $29,400. Another Amendment was filed in 1980 that identified Kings Point

Corporation (Kings), a private corporation with which Laird was associated, as a new general partner; Fisher was reclassified as a limited partner.

The Land

On November 1, 1975, BIO executed a Contract of Sale purporting to sell an 80-acre tract of land (the land) to RK-11 for $458,000 (approximately $5,725 per acre). The land was part of a 977-acre tract of undeveloped property held by Seniel Ostrow as trustee for a certain family trust. The purchase price of the land included a down payment of $8,000 cash and a nonnegotiable, nonrecourse promissory note for $450,000. The promissory note, dated December 31, 1975, was secured by the land. It acknowledged, without further explanation, an underlying encumbrance on the property and included the following terms of payment:

> (a) Loan Points of $112,500.00 (i.e., 25 points @ 1%).
>
> (b) Prepaid interest for the period from November 1, 1975 to December 31, 1976 at 5.4% per annum payable on or before December 31, 1975 in the amount of $28,350.00.
>
> (c) Interest only monthly installments commencing on January 31, 1977 and continuing and including an installment on December 31, 1980.
>
> (d) Monthly installments of principal and interest in the amount of $2,605.00 commencing on February 1, 1981 and continuing approximately 30 years until the Note is paid in full.

The Contract of Sale and promissory note were executed by Laird as the president of Cal-Am, which was the general partner of RK-11, and by Fisher as the secretary of BIO. Neither document was recorded.

On December 29, 1975, Seniel Ostrow conveyed by Individual Grant Deed the 977-acre tract of undeveloped property (the Ostrow property) to GO for $2 million (approximately $2,047 per acre) to be paid pursuant to a promissory note for $2 million. A Deed of Trust and Assignment of Rents in favor of the seller was executed by Laird and another corporate officer on behalf of GO. The Grant Deed and Deed of Trust were recorded on December 31, 1975. The promissory note required monthly payments of interest only at 7 percent per annum to commence on February 1, 1977, and to continue for 5 years. Thereafter, the note would be amortized over a period of 20 years. GO agreed to pay property taxes commencing in 1975. On December 31, 1975, GO conveyed the Ostrow property to BIO for $2 million by means of a Corporate Grant Deed executed by Laird and Fisher and recorded on the same day. In accordance therewith, BIO assumed the $2 million promissory note executed by GO in favor of Seniel Ostrow.

On February 10, 1978, Laird executed a Grant Deed in lieu of foreclosure granting to Seniel Ostrow the Ostrow property acquired by GO on December 29, 1975, and subsequently conveyed to BIO. The deed identified an unpaid debt of $2 million.

The Condominiums

On December 22, 1975, GO entered into a Sales Contract to purchase certain Royal Kuhio condominium units from Asahi Development Hawaii Corporation (Asahi), who was then building the condominiums. Included in the purchase were 39 units on floors 26, 27, and 28 at a total cost of $2,318,400. Pursuant to the contract, GO was required to pay 25 percent of that amount by the time construction of the units was completed in the fall of 1976. The balance of the purchase price would be financed by a first mortgage from a lending institution. The Royal Kuhio condominium project was registered with the Land Court in Hawaii, and Asahi completed construction of the condominiums in August 1976.

In a Contract of Sale dated November 1, 1975, GO purported to sell three Royal Kuhio condominiums to RK-11 for $210,000. The contract was executed by Laird as the president of Cal-Am, which was the general partner of RK-11, and by Fisher as the vice president and secretary of GO. The contract identified the condominiums, in typewritten form, as units 1307, 1309, and 1310. This language, however, was crossed out, and handwritten notations, which were initialed by the parties, were added identifying the units as 2701, 2702, and 2703. Condominium units 1307, 1309, and 1310 were never acquired by GO or any other Cal-Am related entity. The Contract of Sale was not recorded, and no Transfer Certificate of Title between GO and RK-11 for any condominiums allegedly purchased by RK-11 was ever filed with the Land Court.

The terms of purchase described in the Contract of Sale required a down payment of $12,000 and a promissory note for $198,000. The unrecorded note, which was dated December 31, 1975, and executed by the same parties who executed the Contract of Sale, was payable over a period of 35 years as follows:

(a) Loan Points of $39,600 (i.e, 20 points).

(b) Prepaid interest for the period from November 1, 1975 to December 31, 1976 at 7.5% per annum payable on or before December 31, 1975 in the amount of $17,325.

(c) Interest only monthly installments commencing on January 31, 1977 and continuing and including an installment on December 31, 1980.

(d) Monthly installments of principal and interest in the amount of $1,385 commencing on February 1, 1981 and continuing approximately 30 years until the Note is paid in full.

The note recognized, without further explanation, an underlying obligation on the property of approximately $170,700. As in the Contract of Sale, units 1307, 1309, and 1310 were typewritten and scratched out, and units 2701, 2702, and 2703 were handwritten and initialed by the parties. The note was nonnegotiable and nonrecourse.

In August 1976, GO filed a complaint against Asahi for breach of contract of sale and sought specific performance or damages. The main issue in the litigation concerned the financing of the prospective purchases by GO. As a result of settlement negotiations, the parties filed a Stipulation for Dismissal with Prejudice on December 10, 1976. As agreed by the parties, certain units would be transferred to GO in December 1976 and January 1977.

On December 13, 1976, certain condominium units were conveyed to GO, including units 2701, 2702, and 2703. The documents conveying these units were recorded with the Land Court of Hawaii on December 21, 1976. The purchase prices of units 2701, 2702, and 2703 were $67,700, $56,800, and $55,800, respectively.

On July 24, 1978, GO sold by Deed and Assignment units 2702 and 2703 to the Royal Hawaiian Adventure Club of Hawaii. On August 31, 1978, GO sold by Deed and Assignment unit 2701 to the same party. Both documents were recorded with the Land Court of Hawaii.

Partnership Files

Cal-Am, the general partner in each of the 49 limited partnerships, maintained two sets of files for each partnership. A legal file contained certain contracts, promissory notes, leases and income tax returns. A subscription file contained completed offering questionnaires and a copy of each limited partner's contribution check. Similar documents were included in the files of every partnership.

In addition to the RK-11 Certificate of Limited Partnership, the two Amendments thereto, the Private Offering Memorandum, the Contract of Sale for the land, the Contract of Sale for the condominiums, and the promissory notes executed at or about the time of those Contracts of Sale, the RK-11 legal file contained the following documents:

Document	Description
Legal Retainer Agreement (December 1, 1975)	Retaining legal services of Laird Inc., including the preparation of documents, unrecorded; signed by Laird for both parties.
Promissory Note (November 1, 1975)	RK-11 to pay Fisher Inc. $180,735; unrecorded; nonrecourse; collateral: the land allegedly purchased by RK-11; signed by Yates for RK-11.
Promissory Note (December 31, 1975)	GO to pay Cal-Am $12,600; unrecorded; nonrecourse; collateral: (in handwritten form) condominium units 1201, 1202, 1203 (units 1307, 1309, 1310 were typewritten and scratched out); signed by Laird for GO.
Promissory Note (December 31, 1975)	GO to pay Cal-Am $30,000; unrecorded; nonrecourse; collateral: (in handwritten form) condominium units 1201, 1202, 1203 (units 1307, 1309, 1310 were typewritten and scratched out); signed by Laird for GO.
Declaration of Trust (December 31, 1975)	Cal-Am, trustee, to hold the $30,000 GO note for the benefit of RK-11 partners; unrecorded; signed by Laird for Cal-Am.
Post-Organization Management Agreement (December 1, 1975)	Fisher Inc. to initiate procedure for operations of land and condominiums allegedly owned by RK-11 for fee; unrecorded; signed by Laird for RK-11 and by Fisher for Fisher Inc.
Management Agreement (January 1, 1976)	Cal-Am to manage certain land and condominiums allegedly owned by RK-11 for annual fee; unrecorded; signed for both parties by Laird.
Lease (December 31, 1975)	LMC to lease for 1 year with option to purchase the land allegedly owned by RK-11 (rent of $2,000 in 1976); unrecorded; signed by Fisher for LMC and Laird for RK-11.

Lease (February 1, 1977)	Kings to lease on a year-to-year basis condominium units 2701, 2702, and 2703 from RK-11 (for $500 per month per unit); unrecorded; signed by Laird for both parties.
Option Agreement (December 31, 1975)	Granting LMC an option to purchase the land (at its adjusted basis plus 150 percent of the amount of the nonrecourse loans to RK-11 by Fisher Inc.) and condominiums (at their adjusted basis) from RK-11; unrecorded; signed by Fisher for LMC and Laird for RK-11.
Assignment of Options (October 1, 1977)	To assign all of LMC's options in certain partnerships to Kings; unrecorded; signed by Laird for both parties.
Notice of Exercise of Option (December 31, 1980)	To notify Cal-Am that Kings was exercising its option to purchase certain condominiums, including 2701, 2702, and 2703; unrecorded; signed by Kenneth Yates for Kings and Laird for Cal-Am.

The RK-11 legal file did not contain grant deeds to or from RK-11 for either the condominium units or the land.

Financing

Cal-Am maintained a special account, the Cal-Am Investors Account, into which the cash investments of the limited partners such as petitioners were deposited. The limited partners' contributions to a particular partnership were then made by writing one check on the Cal-Am Investors Account to the limited partnership. The limited partners were also required to make a "loan" to GO in an amount equal to their contribution to the partnership. That "loan" was also paid by one check from the Cal-Am Investors Account.

All 49 limited partnerships had similar financial arrangements that were accomplished entirely through the use of checks. Mechanical instructions in the form of charts and diagrams were prepared under the direction of Laird[2] to be used by Cal-Am employees and bank employees for processing the checks. The employees of Cal-Am prepared all checks and deposit tickets for Cal-Am, LMC, GO, BIO, Fisher Inc., and Laird Inc.

A bank account for RK-11 was opened with a $100 deposit by a Cal-Am check dated December 24, 1975. On December 29, 1975, the bank processed the following transactions for that account:

Charges (by Check)

To the Order of	Amount	Check Number	Description
GO	$ 12,000	1	down payment
BIO	8,000	2	down payment
GO	39,600	3	loan points
BIO	112,500	4	loan points
GO	17,325	5	interest
BIO	28,350	6	interest
Laird Inc.	6,480	7	post-organization legal
Fisher Inc.	6,480	8	post-organization management
	$230,735		

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[2] The parties stipulated that this method of financing was similar to that used by Laird and Cal-Am in 1974 real estate tax shelters and 1976 coal tax shelters. See Beck v. Commissioner, 74 T.C. 1534, 1544-1547 (1980), affd. 678 F.2d 818 (9th Cir. 1982), and Hawley v. Commissioner, docket No. 12316-83, and related cases tried and submitted to the Court.

Deposits

From	Amount	Description
Fisher Inc.	$180,735	loan
LMC	20,000	
Cal-Am	600	
Cal-Am Investors	29,400	L.P. Capital Contribution
	$230,735	

The closing balance in the account for 1975 was $100.

A summary of checks regarding RK-11 that were deposited to and drawn upon the accounts of the entities described in the paragraph above is as follows:

Entity (account)	Deposited	Drawn
RK-11	$230,835	$230,735
GO	98,925	83,925
BIO	148,850	137,480
LMC	40,080	20,000
Fisher Inc.	207,805	200,735
Laird Inc.	6,480	-0-
	$732,975	$672,875

All of these checks, except the initial $100 deposit in RK-11, were dated December 27, 1975. The difference in the total amounts deposited and drawn is $60,100, which is composed of (1) the limited partners' contribution to RK-11 of $29,400, (2) the required "loan" by the limited partners to GO of $29,400, (3) the initial deposit in RK-11 by Cal-Am of $100, (4) the Cal-Am contribution to RK-11 of $600, and (5) the required Cal-Am loan to GO of $600.

In December 1975, Laird-controlled entities conducted banking transactions with outside entities as follows:

Bank Account	Opening Balance 12/17/75	12/17 THROUGH 12/31/75	
		Deposits from Outside Source	Payments to Outside Creditors
Cal-Am Investors	$143,408.92	$1,437,336.00	$ 6,513.15
Cal-Am	2,875.32	113.34	211,227.20
BIO	8,668.96	6,750.00	20,034.34
GO	45,524.98	58,800.00	194,529.06
LMC	-	1,200.00	-
Fisher Inc.	808.88	-0-	82,427.61
Laird Inc.	50.00	-0-	179,374.22
49 Partnerships	1,943.96	-0-	1,931.33
	427.16	1,200.00	-0-
	-	15,000.00	-
	-	58,800.00	-
	-	73,800.00	-
Total	$203,708.18	$1,652,999.34	$696,036.91[3]

Excluding the payments described above, the accounts, at the close of the period described, had available funds totaling $1,856,707.52. During this period, however, the same entities, in following Laird's mechanical financial instructions, wrote 890 checks totaling more than $38 million.

In December 1976, Laird-controlled entities conducted banking transactions with outside entities as follows:

Bank Account	Opening Balance 12/1/76	12/1 THROUGH 12/31/76	
		Deposits from Outside Sources	Payments to Outside Sources
Cal-Am	$ 175.91	$10,000	-0-
LMC	73.15	10,000	-0-
Fisher, Inc.	121.68	-0-	-0-
35 Partnerships	4,592.76	-0-	-0-
	$4,963.50	$20,000	-0-

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[3] Respondent computed this total as $695,936.91. The error in addition has been corrected.

As a result of these transactions, the accounts, at the end of the period, had available funds totaling $24,963.50. During this period, however, the same entities wrote 207 checks totaling more than $2.5 million.

The ability of the entities to write checks in 1975 and 1976 in excess of the actual or real funds present was due to the elaborate check swapping system. The following chart exemplifies the process on a smaller scale and specifically traces a swapping of checks that included RK-11's "payment" of certain expenses in 1976:

Date of Check	Date of Deposit	Amount of Check	Maker	Depositor
Oct. 15	Dec. 10	$ 2,000	Cal-Am	LMC
Oct. 15	Dec. 10	2,000	LMC	RK-11
Oct. 15	Dec. 10	2,000	RK-11	Cal-Am
		(for "1976 MANAGEMENT FEES")		
Oct. 15	Dec. 10	18,073	Cal-Am	RK-11
Oct. 15	Dec. 10	18,073	RK-11	Fisher Inc.
		(for "1976 INTEREST")		
Oct. 15	Dec. 10	18,073	Fisher Inc.	Cal-Am

Each of these checks was signed jointly by Fisher and Yates.

Partnership Returns

The RK-11 partnership returns for 1975 and 1976 reported gross receipts of only $2,000 rental income from LMC in 1976. They claimed deductions for interest, legal fees, and management fees of $210,735 in 1975 and $20,073 in 1976. Neither return reported any deductions for wages, property taxes, repairs, or depreciation.

The 1977 partnership return reported rental income of $16,500 and deductions totaling $21,750 for interest, depreciation, and management fees. No deduction for taxes was claimed. The included balance sheet and attached copy of journal entries reported that RK-11 transferred the land (the portion of the Ostrow property purportedly purchased by RK-11) to LMC for an amount equal to book value.

The 1978 partnership return of RK-11 reported no gross receipts, no deductions, and the sale of the condominium units at cost. Attached to the return was a letter dated March 15, 1979, from Cal-Am to the limited partners; it was signed by Yates and included the following:

> Since our last report to you several important events have taken place which effect [sic] the partnership. On January 1, 1977 the partnership sold its unimproved land parcel to Legal Mortgage Corporation pursuant to the option to purchase granted to Legal Mortgage Corporation, as outlined in the Offering Prospectus. * * * This transaction did not result in a taxable event for the partnership and therefore, no items of income or loss were reportable for 1977.
>
> On January 1, 1978 the partnership also sold the three condominium units owned by the partnership. The condominium units were sold to Kings Point Corporation as the Assignee of the Option to Purchase granted to Legal Mortgage Corporation pursuant to the Offering Memorandum. * * * There is no taxable consequence in 1978 as a result of this sale; and therefore, neither items of income or loss incidental to this transaction nor income and expenses from the operations of the partnership property are reportable for the tax year ending December 31, 1978.

Partnership returns filed for RK-11 for 1979 through 1984 reported no gross receipts and no deductions.

OPINION

This case is representative of cases arising from the activities of 49 real estate limited partnerships (the Cal Am Real Estate Group). The facts in these cases are essentially identical. Certain of the remaining docketed cases have agreed to be bound by the determination reached in this case.

Petitioners claim deductibility of their distributive share of RK-11's 1975 and 1976 partnership losses, which were allegedly composed of interest, management fees, and legal fees. The availability of those deductions turns on whether that partnership's transactions involving the alleged purchase, operation, and sale of certain real property were bona fide arm's-length transactions for Federal income tax purposes.

Petitioners argue that the purchases were reasonable as to cost, that the points and interest charged were reasonable, and that the objective of profit by the partnership was without reference to any projected tax benefits. Respondent's primary argument is that the transactions were shams, conducted solely for the purpose of generating tax deductions. Alternatively, respondent argues that the claimed interest deductions should be disallowed because the partnership never acquired title to or ownership of the property and because the nonrecourse notes greatly exceeded the fair market value of the property, the claimed deductions were never paid, and the management and legal fees were nondeductible capital expenditures. We agree with respondent's primary argument that the transactions were shams; therefore, we do not independently address respondent's alternative arguments, although we do consider some of them in our holding on the sham issue.

Transactions that lack economic substance and are conducted for the sole purpose of reducing tax liability are disregarded as shams by the courts. Knetsch v. United States, 364 U.S. 361 (1960); Falsetti v. Commissioner, 85 T.C. 332 (1985). It is the economic substance of a transaction, not its form, that controls for Federal tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1226 (1981). In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court stated:

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," Commissioner of Internal Revenue v. Tower, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. at 255. See also Commissioner of Internal Revenue v. P. G. Lake, Inc., 356 U.S. 260, 266-267 (1958); Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331, 334 (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant. Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278, 286 (1960). [435 U.S. at 573.]

In that case, the Supreme Court, in concluding that the transactions there in issue were to be recognized for tax purposes, held that where--

> there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. * * * [435 U.S. at 583-584.]

Based on the rationale of these cases, we recently articulated a definition of "'sham in substance' as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." Falsetti v. Commissioner, supra at 347.[4] See Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983). In Falsetti, we considered the totality of the facts and circumstances and determined that the purported purchase of certain real property was a sham because of the absence of transfer of legal title or other indicia of arm's-length dealing, drastically inflated sales prices, and complete disregard of contractual terms.

In this case, we have considered the entire record and conclude that the transactions in issue, i.e., the purported purchase, operation, and sale of the land and condominiums, were shams. This determination is based on many factors including lack of arm's-length dealing, circular money movements, and other questionable business practices. See Karme v. Commissioner, 73 T.C. 1163 (1980), affd. 673 F.2d 1062 (9th Cir. 1982).

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[4] See also Steinert v. Commissioner, T.C. Memo. 1985-581.

A close examination of the entities involved in the purported transactions reveals a complete lack of arm's-length dealing. See Karme v. Commissioner, 73 T.C. at 1186. As indicated throughout the record, Laird and Fisher exercised control over every entity associated with the transactions in issue. Together or individually, they represented the parties on each side of every transaction. For instance, they executed documents on behalf of the seller (BIO, GO) and the buyer (RK-11), the lender (BIO, GO, Fisher Inc.) and the borrower (RK-11), the attorney (Laird Inc.) and the client (RK-11), the optionor (RK-11) and the optionee (LMC), the lessor (RK-11) and the lessee (LMC, Kings), the assignor of the option (LMC) and the assignee of the option (Kings), the trustor (RK-11) and the trustee (Cal-Am), the promoter (Cal-Am) and the limited partnership (RK-11), and the owner (RK-11) and the manager (Cal-Am, Fisher Inc.). Accordingly, there were no negotiations among the entities. In fact, most of the transactions involving the parties described above were prearranged and laid out in detail in the offering memorandum petitioners received, and even the memorandum discussed the existence of common control among the entities.

The absence of arm's-length dealing is indicated by the terms of purchase in the sales contracts and promissory notes regarding the land and condominiums. In addition to interest at 5.4 percent and 7.5 percent, some of which was prepaid, these documents required 25 and 20 loan points on the amounts financed for the land and condominiums, respectively. Respondent's banking and financial expert, who was not impeached or contradicted by petitioners, testified at length regarding points. He stated that the going rate for points in 1975 and 1976 was 1 to 3 points but never more than 5 points, and that 20 or 25 points was unusual, unheard of, and would be considered a "gouge." He also stated that the loan to value ratio on the land (98 percent) was much higher than the industry norm at that time (50 to 60 percent). This testimony is credible, and we accept it. Moreover, we do not believe that independent parties would have agreed to the exorbitant terms of the transactions in issue.

Payment in the form of swapping checks or other types of exchange has been disregarded by the courts. Knetsch v. United States, 364 U.S. 361 (1960); United States v. Clardy, 612 F.2d 1139 (9th Cir. 1980). The circular transfer of money through related parties to create the illusion of payment is an indication of sham transactions. Karme v. Commissioner, 73 T.C. at 1186-1187. In this case, an enormous circular money movement occurred in December of each year in issue. Detailed instructions were provided to Cal-Am employees and banking personnel for the purpose of processing the massive flow of checks during the short time periods. As set forth in the findings of fact, the exchange of checks in each year created an illusion of payment by RK-11 of certain expenses. RK-11 deposited investor contributions and large checks representing unrecorded, nonnegotiable, nonrecourse loans and simultaneously wrote checks for points, prepaid interest, and certain other fees. The checks drawn by RK-11 were far in excess of the partners' actual investment. Indeed, after the dust had settled, RK-11's bank account had the same balance as before the money movement, i.e., the debits exactly equaled the credits, and the only change of substance in the bank accounts overall was a shift of the partners' cash contributions into the accounts of other Laird-controlled entities.

In United States v. Clardy, supra, involving claimed payments for deductible interest, the Court of Appeals for the Ninth Circuit stated:

> By swapping worthless checks which nevertheless offset each other and by securing the cooperation of a friendly bank, they managed to get the checks entered as debits on the relevant bank accounts. It would be difficult, to say the least, for anyone to believe in good faith that this amounted to a payment of interest. [612 F.2d at 1152.]

Likewise, we refuse to give credence to Laird's "financial fantasies." See Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985), affg. 80 T.C. 955 (1983). The check swapping mechanism was no more than a superficial payment structure created solely for tax benefits. See Battelstein v. Commissioner, 611 F.2d 1033, 1035 (5th Cir. 1980). See also Beck v. Commissioner, 74 T.C. 1534, 1562-1564 (1980), affd. 678 F.2d

818 (9th Cir. 1982), where taxpayers' partnerships were denied claimed interest deductions for alleged payments pursuant to a similar Laird-designed financial scheme involving some of the same entities involved in this case.

Other aspects of the partnership's alleged purchases and financing refute petitioners' characterization of the transactions. RK-11's per acre purchase price of the land was almost triple the per acre cost of the same property when it was purchased by recorded grant deed by GO, RK-11's claimed predecessor in interest, in an apparent arm's-length transaction at about the same time. Petitioners' failure to establish that RK-11's price reflected the property's fair market value or to suggest that the acreage value was not uniform is, on these facts, "lethal" to petitioners' case. Karme v. Commissioner, 73 T.C. at 1190. See Falsetti v. Commissioner, 85 T.C. at 350-351.

An examination of the documents in the record reveals highly questionable business practices. RK-11 allegedly purchased the land from BIO on November 1, 1975; however, BIO did not acquire the property from GO (by recorded grant deed) until December 31, 1975, and GO had not acquired the property from Seniel Ostrow (by recorded grant deed) until December 30, 1975. RK-11 purported to purchase the condominiums from GO on November 1, 1975; yet the same units were not conveyed to GO (by recorded documents) until December 13, 1976. See Derr v. Commissioner, 77 T.C. 708 (1981) (a partnership's purported purchase of property was held a sham transaction where the promoter, who contracted to sell the property to the partnership, had not yet acquired ownership of the property).

RK-11 executed several promissory notes secured by the land or the condominiums before the respective properties were acquired. The collateral ultimately acquired, however, was inadequate. RK-11 executed two unrecorded nonrecourse notes in November and December 1975 that totaled $630,735 and that were secured by the land, which was already subject to an undescribed prior encumbrance. The total of the loans substantially exceeded RK-11's purchase price of $458,000. RK-11 also executed three unrecorded nonrecourse notes on December 31, 1975, that totaled $240,600 and were secured by the condominiums allegedly purchased. In addition to a prior encumbrance on the property of $170,700, the loans substantially exceeded RK-11's purchase price of $210,000. In view of these factors, it becomes apparent that the condominiums and the land were wholly insufficient to secure the notes in full.

Moreover, RK-11 did not acquire legal title to the property in issue. Hawaii State law requires that the deed or other instrument must be filed with the Land Court to effectively convey registered property. Hawaii Rev. Stat. sec. 501-101 (1976). No such document, however, was filed with respect to any condominiums allegedly purchased by RK-11 from GO. There were no grant deeds for either the condominiums or the land to or from RK-11, although they do exist (recorded) to and from BIO to GO.

Other questionable business practices include (1) the handwritten alteration of the condominium unit numbers on some of the documents but not others, (2) the promise that partnership expenses would be paid out of nonrecourse loans from Fisher Inc., and (3) the absence of recordation of any of the documents in the partnership legal file.

For all of the foregoing reasons, we conclude that the partnership transactions were shams, conducted for the sole purpose of generating tax deductions. Accordingly, respondent's determination disallowing petitioners' share of the partnership losses is sustained.

Decision will be entered

for the respondent.

JU11.7/2:1986-321

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T. C. Memo. 1986-321

UNITED STATES TAX COURT

JOHN A. HIRST, Petitioner, v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 31291-83. Filed July 28, 1986.

Petitioner participated as a pilot, off-loader, and lookout in marijuana smuggling activities during 1980. *Held*, petitioner received $29,500 in taxable income for his involvement in marijuana smuggling activities. *Held further*, petitioner realized a long-term capital gain of $29,250 upon his transfer of property in satisfaction of a promissory note. *Held further*, petitioner is liable for the self-employment tax on income received by him for his participation in marijuana smuggling activities. *Held further*, petitioner is not liable for an addition to tax pursuant to sec. 6653(b).

ORIG

John A. Hirst, pro se.

Max K. Boyer, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in petitioner's 1980 Federal income tax in the amount of $68,173.27 together with an addition to tax pursuant to section 6653(b)[1] in the amount of $34,086.64. The issues presented for consideration are:

(1) Whether petitioner received unreported taxable income of $104,000 from marijuana smuggling activities;

(2) whether petitioner realized a long-term capital gain of $32,000 upon his transfer of real property in satisfaction of a promissory note;

(3) whether the taxable income received by petitioner from marijuana smuggling activities constitutes self-employment income;

(4) whether petitioner's underpayment of tax was due to fraud.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner John A. Hirst (Hirst) resided in Marianna, Florida, at the time his petition was filed. Hirst and his wife, Nancy Hirst, filed separate returns for the calendar year 1980.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

Subsequent to the issuance of the notice of deficiency involved herein, Hirst filed an amended return showing a net increase of $13,000 in his taxable income due to his involvement in marijuana smuggling activities during the period March to July 1980.

Hirst was employed as an aircraft mechanic in Marianna until April 15, 1980. While employed as a mechanic, Hirst installed long-range fuel tanks and performed maintenance on planes owned or operated by Charles Etheridge, Sr. (Etheridge). Etheridge had been involved in drug smuggling activities prior to the events at issue, but Hirst had not.

In March 1980, Etheridge approached Hirst about the possibility of participating in marijuana smuggling activities. Hirst was receptive to the idea, and participated in four "runs" during the month of April. On April 1, Hirst acted as lookout and unloader for a twin engine Beachcraft plane. Hirst was to be paid $4,000 for his participation in this run. Approximately 1 week later, Etheridge and Hirst attempted to fly an aircraft south from Florida to pick up marijuana. The plane had mechanical problems, however, which forced them to return to Florida without picking up the load. Later in April, Etheridge and Hirst flew an aircraft to Jamaica, picked up 600 pounds of marijuana, and successfully returned to Florida. Hirst was to be paid $20,000 as pilot and unloader on this third trip. Shortly after his successful run to Jamaica, Hirst again acted as lookout and unloader for the twin engine Beachcraft.

The final two loads of marijuana were taken to Dothan, Alabama, for sale to prearranged buyers. The expected sale did not occur, however, and Etheridge and Hirst were forced to look for alternative buyers. Negotiations were held at Hirst's house in Marianna with prospective buyers located by Hirst. Etheridge subsequently returned to Dothan, but was arrested with the marijuana prior to its disbursement. Hirst was not arrested for his participation in the April 1980 runs, and Etheridge was subsequently released on bail. Prior to Etheridge's arrest, Hirst was paid a total of $3,000 by Etheridge for acting as pilot, lookout, and unloader.

In July 1980, Etheridge and Hirst conspired with numerous other people to smuggle marijuana into the United States aboard a DC-6 aircraft. The plan called for picking up approximately 10,000 pounds of marijuana, making this a significantly larger operation than those undertaken in April. Etheridge was responsible for arranging the unloading of the aircraft upon its arrival in Florida, and was to fly in the plane as part of the crew. Etheridge was to be paid a salary of $100,000 for his participation. Operations on the ground were supervised by Don Kirshner (Kirshner), who was associated with the owners of the aircraft. Etheridge recruited Hirst to participate as a member of the unloading crew, which was responsible for setting up the runway lights, unloading the aircraft, and refueling the plane.

Hirst was specifically responsible for providing a fuel truck. The unloading crew was to be paid a commission of 10 percent based on a value of $250 a pound of marijuana.

Prior to the expected date of arrival of the DC-6, Hirst held at least one meeting at his house to make arrangements for unloading the aircraft. Hirst wanted some security to insure that the unloading crew would receive its 10-percent commission. Consequently, it was agreed that Hirst would hold 10 percent of the marijuana unloaded from the plane as security.

The DC-6 was to be flown from Colombia to Florida on July 4, 1980. Due to logistical problems in Colombia, the crew was unable to return the plane to Florida until the night of July 7. Upon the plane's arrival, Hirst loaded his pickup truck with bales of marijuana to be stored in his attic as security pursuant to the prior agreement. The amount of marijuana actually on the plane, and the amount held by Hirst as security, is undetermined. The remainder of the marijuana was loaded into a truck and taken to Tallahassee, Florida.

Etheridge drove to Miami to receive the initial installment on funds owed to him and the unloading crew. Etheridge received $5,500 from the owners of the aircraft as an initial payment. Etheridge and Hirst were in communication throughout this period, and Etheridge assured Hirst that additional payments were to be received. Based upon Etheridge's assurances, and with some concern for his personal welfare, Hirst gave the marijuana held by him to the principal smugglers approximately 1 week after the landing. At the time Hirst relinquished the marijuana, he had received no payment for his participation in the landing.

Approximately 2 weeks after the landing, Hirst drove from Marianna to Miami to pick up the initial installment on the unloading crews' 10-percent commission. While in Miami, Hirst was paid $19,500 by Etheridge in 10-, 20-, and 50-dollar bills. It was at this time that Hirst and Etheridge agreed upon the amounts to be paid by them to various members of the unloading crew. The amount each member was to be paid was recorded in a small black book carried by Etheridge. Hirst was to act as a conduit for Etheridge in satisfaction of Etheridge's obligations to certain members of the crew. Hirst subsequently received an additional payment of $10,000 when Etheridge returned to Marianna, and a payment of $2,000 from Carlos Berreta in Tallahassee, Florida. Hirst used $5,000 of the $31,500 received by him to pay a co-conspirator's attorney's fees.[2]

Etheridge and Hirst were joined by their wives in Miami at the time Etheridge paid Hirst the $19,500. While in Miami, Hirst purchased a motorcycle for approximately $4,000, a video cassette recorder and movies for approximately $1,000 and some clothing for his wife for approximately $200. Additionally, at some point in 1979-1980, Hirst purchased a new automobile for his wife.

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[2] Hirst testified that out of the $26,000 he admitted receiving, he distributed $5,000 to one of his helpers and $3,000 to another in addition to this $5,000. Payment of the $5,000 was substantiated by testimony of the recipient, but there was no corroboration of the two additional payments.

On August 6, 1980, Hirst borrowed $35,000 from his father to purchase a house. Hirst intended to repay his parents with proceeds from his participation in the DC-6 landing. According to representations made by Etheridge, Hirst had reason to believe that $85,000 in additional proceeds were forthcoming.

On August 7, 1980, Hirst purchased a house in Marianna for $34,300. He paid for it with the funds borrowed from his father in the form of two cashiers checks issued by his parent's bank and in his mother's name. Of this amount, $22,800 was paid to the owners of the house and $11,500 was paid to the bank in satisfaction of a second mortgage on the property. Included in the payment to the bank was an amount sufficient to prepay the mortgage payments for 1 year.

On November 25, 1980, Hirst transferred his undivided one-half interest in real property located in Washington County, Florida to his parents. The property was owned jointly by Hirst and his first wife. The transfer was made in satisfaction of the $35,000 promissory note given to his parents on August 6, 1980. Hirst and his former wife had purchased the Washington County property on May 6, 1971. Hirst claimed a purchase price of $12,000, and entered into evidence a policy of title insurance for $11,500. The property was used as security for a loan borrowed by Hirst and his first wife on March 31, 1971, in the amount of $16,800.

On August 12, 1980, Hirst and Nancy Hirst were arrested with a number of his fellow conspirators for their activities associated with the DC-6 flight. After Hirst's arrest, Nancy Hirst posted a bond of $5,000 to secure his release. Hirst was found guilty of conspiring to possess marijuana with intent to distribute and his conviction was affirmed upon appeal to the Eleventh Circuit. Nancy Hirst was found not guilty. Hirst was represented on appeal by John Daniel (Daniel), who had represented Nancy Hirst during discovery and trial. Daniel advised Hirst as to tax matters and prepared his original 1980 return on which no smuggling income was reported.

The ringleader of these activities was Etheridge, who has since testified in cooperation with the Government in return for leniency towards his son, who was also involved in the plot.

ULTIMATE FINDINGS OF FACT

(1) Hirst received $34,500 for his participation in marijuana smuggling activities.

(2) Hirst distributed $5,000 of his receipts in satisfaction of a co-conspirator's attorney's fees.

(3) Hirst transferred his undivided one-half interest in the Washington County property to his parents in satisfaction of his $35,000 debt to them.

OPINION

The first issue for decision is whether Hirst received unreported taxable income of $104,000 from his marijuana smuggling activities. Respondent's determination is presumptively correct, and the burden of proof rests with petitioner. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). This issue is an entirely factual one, to be decided on the basis of Etheridge's and Hirst's conflicting testimony. As an initial observation, neither Etheridge nor Hirst impressed us as being a particularly credible witness. Both were admittedly involved in a conspiracy to smuggle marijuana into the United States, and both have an interest in minimizing the proceeds received and retained by them. Etheridge admits to having received approximately $264,000, and contends that he transferred approximately $165,000 of this amount to Hirst. Hirst admits to having received $26,000 from Etheridge, and contends that he transferred $13,000 of this amount to fellow conspirators.

As the trier of fact, we are convinced that neither Etheridge's nor Hirst's version of events is wholly correct. Accordingly, we have adopted the most credible portions of the testimony presented, and have also considered facts as to the money otherwise earned, borrowed, and expended by Hirst during the period at issue. Having carefully weighed all of the evidence available to us, including the conflicting testimony, we have determined the facts to be as set forth in our findings. On this basis we found that Hirst received and retained $3,000 for his participation in the April 1, 1980 run, not $4,000 as respondent contends. Additionally, we found that Hirst received $31,500 for the DC-6 run, and retained $26,500 of this amount.

We are satisfied that Hirst acted as a mere conduit as to $5,000. We are not persuaded that he passed on to his associates more than this sum. In Diamond v. Commissioner, 56 T.C. 530 (1971), affd. 492 F.2d 286 (7th Cir. 1974), we stated:

> We accept as sound law the rule that a taxpayer need not treat as income moneys which he did not receive under a claim of right, which were not his to keep, and which he was required to transmit to someone else as a mere conduit. * * * [56 T.C. at 541.]

Accordingly, we reduce Hirst's gross receipts by $5,000. See James v. United States, 366 U.S. 213, 219 (1961); North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932). Thus, we found that Hirst received $29,500 in taxable income for his involvement in marijuana smuggling activities during 1980.[3]

The next issue for decision is whether Hirst recognized a long-term capital gain of $32,000 upon his transfer of the Washington County property to his parents in satisfaction of the $35,000 note. Respondent contends that Hirst had a $3,000 basis in his one-half interest in the property, and that the transfer constituted a taxable exchange pursuant to section 1001. Hirst contends that he and his former wife purchased the property for $12,000 and that his one-half interest was transferred to his parents as security for the $35,000 loan. We conclude that Hirst and his former wife purchased the property for $11,500 based on the amount of title insurance taken out on the property at the time of purchase.[4] Additionally, we find that Hirst transferred his one-half interest in the property to his parents in satisfaction of the $35,000 as stated in the quit-claim deed used to transfer title to his parents.[5] Hirst had a basis of $5,750 in his undivided one-half interest, and realized a long-term capital gain of $29,250 upon his transfer of the property in satisfaction of the note.[6]

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[3] This amount includes the $13,000 previously recognized by Hirst in his amended 1980 return.

We must next decide whether Hirst was engaged in the trade or business of smuggling marijuana in 1980 as a self-employed individual. The tax on self-employment income is part of the income tax and is subject to the jurisdiction of the Tax Court to the same extent and in the same manner as the income tax. Section 1.1401-1(a), Income Tax Regs. Respondent has taken the position that the tax is imposed on individuals engaged in illegal activities where they otherwise qualify. See Rev. Rul. 60-77, 1960-1 C.B. 386. The burden is on the taxpayer to show that he is not liable for the tax. Rule 142(a). Since petitioner offered no proof on this issue, respondent's determination is presumed to be correct. Accordingly, petitioner is liable for the self-employment tax on income received by him for his participation in marijuana smuggling activities during 1980.

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[4] Hirst entered as evidence a warranty deed dated May 6, 1971 conveying the Washington County property to him and his former wife. Stamps affixed to the deed indicate the payment of a Florida documentary stamp tax of $34.50. Pursuant to Fla. Stat. §201.02(1) (1971) a tax of $.30 for each $100 of consideration paid is levied upon instruments conveying an interest in real property. A purchase price of $11,500 would result in a stamp tax of $34.50. Thus, the stamp tax supports our conclusion that Hirst paid $11,500 for the Washington County property as suggested by the policy of title insurance.

[5] The quit-claim deed from Hirst to his parents reads in part as follows: "This deed is given in full satisfaction of that one certain promissory note, dated the 6th day of August, 1980, from John A. Hirst to John Y. Hirst and wife, Hazel Hirst, in the amount of $35,000.00."

[6] On brief, respondent argues that Hirst's parents knew about Hirst's smuggling activities, and that Hirst's father knowingly allowed smuggling proceeds to be laundered through his account. While Hirst's father may have had cause to question how Hirst expected to repay the $35,000 loan, we have no reason to believe that his father knew of Hirst's smuggling activities, much less allowed his account to be used to launder funds.

The final issue for decision is whether Hirst's underpayment of tax was due to fraud pursuant to section 6653(b). Under section 6653(b) respondent has the burden of proof by clear and convincing evidence. Section 7454(a); Rule 142(b). To meet this burden, respondent must show that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Rowlee v. Commissioner, 80 T.C. 1111 (1983). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion, 578 F.2d 1383 (8th Cir. 1978); Estate of Pittard v. Commissioner, 69 T.C. 391 (1977). Fraud is not to be imputed or presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970); Otsuki v. Commissioner, 53 T.C. 96 (1969). Fraud may be proven by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. The taxpayer's entire course of conduct may be examined to establish the requisite fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, supra at 105-106 (1969).

Respondent contends that, at the time his 1980 return was filed, Hirst failed to report a substantial amount of smuggling income on which he knew a tax was owed. Hirst concedes that some income had been received, but maintains that its omission was an oversight and not an attempt to evade the payment of tax. Hirst's return was prepared by Daniel, who was concurrently handling Hirst's appeal to the Eleventh Circuit and who had represented Nancy Hirst during the trial.

In light of respondent's burden of proof, we are not convinced that Hirst failed to report his smuggling income with a "specific purpose to evade a tax believed to be owing." Carter v. Cambell, 264 F.2d 930, 936 (5th Cir. 1959); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), affg. a Memorandum Opinion of this Court. Hirst is not a sophisticated businessman. He relied upon the advise of Daniel as to both the preparation of his return and the handling of his appeal.[7] Hirst maintains, and we believe, that he was preoccupied with the appeal of his criminal conviction and did not question the return prepared by Daniel. Daniel knew of Hirst's criminal activities and must have known that Hirst had received some income therefrom. Thus, Daniel was in possession of information necessary to prepare Hirst's return or at least to make appropriate inquiry. Hirst became concerned about the omission subsequent to his release from prison, and filed an amended return at that time. While the facts may create a suspicion of fraud, "[m]ere suspicion of fraud and mere doubts as to the intentions of the taxpayer are not sufficient proof of fraud." Switzer v. Commissioner, 20 T.C. 759, 765 (1953).

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[7] Respondent did not call Daniel to testify as to his preparation of Hirst's return. Therefore, we do not know why Daniel failed to include any smuggling income on the return despite his knowledge of Hirst's activities. On brief, Hirst suggests that Daniel felt it would jeopardize Hirst's appeal. Regardless of Daniel's reasoning, his involvement in the preparation of the return weighs against our finding fraud.

Therefore, respondent has not met his burden of showing, by clear and convincing proof, that petitioner received and deliberately failed to report substantial amounts of income with the intent to evade the payment of income tax. We conclude that fraud has not been proven and that the additions to tax provided in section 6653(b) are inappropriate.

Decision will be entered
under Rule 155.

JU11.7/2: 1986-322

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T. C. Memo. 1986-322

UNITED STATES TAX COURT

LEON C. LOFTIN, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8689-85. Filed July 29, 1986.

Ruth Anne Tarletz, for the petitioner.

James J. Everett, for the respondent.

MEMORANDUM OPINION

FEATHERSTON, Judge: Respondent's Motion To Dismiss For Lack Of Jurisdiction was assigned to Special Trial Judge Lee M. Galloway pursuant to section 7456(d)(4)[1] and Rule 180, for hearing and consideration. The Court agrees with and adopts his opinion which is set forth below.

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all "Rules" references are to the Tax Court Rules of Practice and Procedure.

G. M

ORIGINAL

OPINION OF THE SPECIAL TRIAL JUDGE

GALLOWAY, Special Trial Judge: A hearing on respondent's Motion To Dismiss For Lack Of Jurisdiction was held at the Court's Trial Session at Phoenix, Arizona. The parties appeared[2] and submitted oral argument, exhibits, and written memorandums in support of their positions. Respondent seeks dismissal of the petition on the ground that it was not filed within the time prescribed by sections 6213(a) or 7502.

Respondent determined a deficiency in petitioner's 1981 Federal income tax and additions to tax in his notice of deficiency letter dated December 28, 1984, as follows:

		ADDITIONS TO TAX		
YEAR	DEFICIENCY	SEC.6651(a)	SEC.6653(a)(1)	SEC.6653(a)(2)
1981	$11,116	$ 1,875	$ 555.80	50% of the interest due on $11,116

Petitioner was a resident of Buckeye, Arizona, at the time of filing his petition. The record discloses that respondent mailed the notice of deficiency by certified mail (No. 77757) from Ogden, Utah, on December 28, 1984, to petitioner, addressed as follows:

Leon C. Loftin
941 E. Monroe Space 81
Buckeye, AZ 85326

Section 6213(a) permits the filing of petitions to this Court. It provides in part that:

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[2] Petitioner was represented by his attorney. He did not attend the hearing.

> SEC. 6213(a). TIME FOR FILING PETITION AND RESTRICTION ON ASSESSMENT.--Within 90 days * * * after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. * * *

The 90th day after the mailing of the notice of deficiency was Thursday, March 28, 1985. The petition was dated March 25, 1985,[3] and filed with this Court on April 11, 1985, 104 days after the mailing of the notice of deficiency. The petition was mailed in an envelope from Phoenix postmarked April 8, 1985, 101 days after the mailing of the notice of deficiency.

Petitioner admits that he received the notice of deficiency on February 28, 1985, but asserts that he was "prejudiced" in that respondent's notice was not received in sufficient time for him to file a timely petition. Petitioner also claims that respondent failed to mail the notice of deficiency to his "last known address" as provided by section 6212(b)(1).

Petitioner cannot prevail in this proceeding unless the alleged error in the notice of deficiency prevented him from filing a timely petition with this Court. The courts have held that a notice of deficiency is not necessarily invalidated even though it was not mailed to a taxpayer's "last known address."

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[3] The petition and request for place of hearing were signed by petitioner's attorney. Above her signature on each document were the words "DATED this 25th day of March 1985."

In the case of Clodfelter v. Commissioner, 527 F.2d 754, 756 (9th Cir. 1975), affg. 57 T.C. 102 (1971),[4] the Court of Appeals stated:

> Taxpayers insist that the mailing specified by section 6212 must be to the "last known address" of the taxpayer or it is wholly insufficient. We cannot agree. [Footnote omitted.]
>
> Reading the interrelated sections of the Code as an integrated whole, it is apparent that the legislative plan contemplates that actual notice of the deficiency should be given where such can reasonably be achieved and that the mailing authorized by section 6212(a) is a means to that end. "Last known address" is not even mentioned in that subsection. [Footnote omitted.] A mailing that effectively results in actual notice is what is apparently contemplated by the legislative plan.

In Mulvania v. Commissioner, 81 T.C. 65, 69 (1983), we found the taxpayer received a notice of deficiency without prejudicial delay which was mailed to him at an address which may not have been his "last known address." We held, at page 69, that "inaction, after receipt of the notice, was responsible for the late filing." Given the absence of prejudicial delay in delivery to the taxpayer in Mulvania of the notice of deficiency, respondent's motion to dismiss for lack of jurisdiction was granted.

In this case, the record discloses that petitioner's 1982 and 1983 tax returns were prepared by petitioner's attorney (hereinafter sometimes referred to as Ms. Tarletz) on April 11,

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[4] See also Mulvania v. Commissioner, 769 F.2d 1376 (9th Cir. 1985), affg. T.C. Memo. 1984-98.

1983 and April 16, 1984, respectively. Both returns disclosed petitioner's address to be P.O. Box 1266, Buckeye, Arizona 85326, and reflected overpayments of Federal income tax. Ms. Tarletz also prepared a delinquent 1981 tax return for petitioner on January 24, 1985, less than one month after respondent mailed his notice of deficiency for that year, which disclosed additional tax due of $4,855. This return was mailed from Phoenix on January 31, 1985, and stamped received by the Ogden Service Center on February 6, 1985.

The 30-day letter[5] concerning the 1981 year, and dated August 15, 1984, as well as the notice of deficiency were mailed to petitioner at 941 E. Monroe Space 81, Buckeye, Arizona 85326 (the E. Monroe address). Petitioner's attorney admits that she received both the 30-day letter and the notice of deficiency from petitioner. She also states that petitioner received the notice of deficiency on February 28, 1985. Respondent argues that the petition to this Court "was, apparently, already prepared by March 25, 1985 and, if it had been mailed that day, or any one of the subsequent three days, it would have been timely filed."

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[5] The form 30-day letter relates to petitioner's failure to "respond to (respondent's) requests" concerning his failure to file a delinquent 1981 tax return. However, the record does not disclose whether petitioner received correspondence at the E. Monroe address prior to August 15, 1984. We also note that during the years 1980-1983, petitioner worked for Bechtel Corporation as a construction worker. Petitioner and his former wife filed a 1980 joint return disclosing a San Antonio, Texas, address with the Internal Revenue Service Center in Austin, Texas, which return reported an overpayment of income tax totaling $1,150.

We have here a taxpayer who worked for the same construction company during the years 1980-1983. He claimed a refund on a timely 1980 joint return filed with his former wife in Texas. By 1982, petitioner, now divorced, had moved to Buckeye, Arizona, 55 miles west of Phoenix. Petitioner failed to file a 1981 tax return when due on April 15, 1982. However, petitioner did engage his Phoenix attorney to prepare timely 1982 and 1983 tax returns. But it was months after these returns were filed before petitioner notified Ms. Tarletz (by means of giving her the 30-day letter) that he had failed to file a 1981 tax return. She then prepared his 1981 return and filed it. Approximately a month before the expiration of the 90-day period for filing a petition in this Court, the notice of deficiency was admittedly received. The petition is dated March 25, 1985, three days before the 90-day period expired.[6] We find that petitioner was not prejudiced by the use of the E. Monroe address in the notice of deficiency.

Petitioner relies heavily on Looper v. Commissioner, 73 T.C. 690, 699 (1980), in support of his argument that we should take jurisdiction in this matter. Looper, however, is of no assistance to petitioner. In that case, the taxpayer had 17 days remaining (upon receiving the notice of deficiency) to file a timely petition to this Court. We also observed that the notice of transferee liability in Looper did not concern either the taxpayer's personal tax liability or the liability of an entity with which he had close association at the time he received the notice. The complex issues facing the taxpayer in Looper in the remaining time to file his timely petition make it clearly distinguishable from this case. Here, the crucial fact is petitioner's admission of receipt of the notice of deficiency no later than February 28, 1985, when ample time remained to file a simple 1-1/2 page petition. The principal issue raised in that petition was petitioner's filing status as single rather than married filing separately. Accordingly, we find that petitioner actually received the notice of deficiency without prejudicial delay and that his failure to file a timely petition in this case was due to his inaction after receiving the notice of deficiency. See Mulvania v. Commissioner, supra at 69. For the reasons stated above, we grant respondent's motion to dismiss for lack of jurisdiction.[7]

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[6] Petitioner's attorney attempts to explain the date on the petition as follows: "When it (the notice of deficiency) was received there was insufficient time left to prepare and file prior to the deadline. The date of March 25, 1985 on the Petition resulted from a date left in Petitioner's attorney's computer indicating the last date she used same (So, therefore, it is most likely that the documents were received by Petitioner's counsel after March 25.)" There is no independent evidence to support this assertion.

An appropriate order will be entered.

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[7] In view of our holding, we find it unnecessary to discuss petitioner's second contention that the notice was not mailed to his "last known address."

JU11.7/2:1986-323

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T. C. Memo. 1986-323

UNITED STATES TAX COURT

EDWARD F. RYBECKI, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25273-84. Filed July 29, 1986.

Held: (1) Deficiencies in income tax for 1980 and 1981 sustained.

(2) Additions to tax under sec. 6651(a), I.R.C. 1954 (for failure to file), sec. 6653(a), I.R.C. 1954 (for negligence or intentional disregard of rules and regulations), and sec. 6654, I.R.C. 1954 (for underpayment of estimated taxes), sustained.

(3) The United States is entitled to an award of damages under sec. 6673, I.R.C. 1954.

Edward F. Rybecki, pro se.

Rosabel I. Seigan, for the respondent.

C. M

ORIGIN

MEMORANDUM FINDINGS OF FACT AND OPINION

SIMPSON, Judge: The Commissioner determined the following deficiencies in, and additions to, the petitioner's Federal income taxes:

		Additions to Tax		
Year	Deficiency	Sec. 6651(a) I.R.C. 1954[1]	Sec. 6653(a) I.R.C. 1954[2]	Sec. 6654(a) I.R.C. 1954
1980	$3,108.00	$ 517.50	$155.40	$115.87
1981	5,310.00	1,327.50	$265.50 plus 50% of the interest due on $5,310.00	406.85

The issues for decision are: (1) Whether the petitioner is liable for the deficiencies as determined by the Commissioner; (2) whether the petitioner is liable for the additions to tax under section 6651(a) for failure to file timely returns; (3) whether the petitioner is liable for the additions to tax under section 6653(a) for negligence or intentional disregard of rules and regulations; (4) whether the petitioner is liable for the additions to tax under section 6654(a) for underpayment of estimated taxes; and (5) whether the United States is entitled to an award of damages under section 6673.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

[2] Sec. 6653(a) was amended by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172. Sec. 6653(a) has been redesignated as sec. 6653(a)(1), and sec. 6653(a)(2) has been added. Sec. 6653(a) as amended is effective for "taxes the last date prescribed for payment of which is after December 31, 1981."

FINDINGS OF FACT

None of the facts have been stipulated.

The petitioner, Edward F. Rybecki, was a legal resident of Oaklawn, Ill., at the time he filed his petition in this case. He filed no Federal income tax returns for 1980 and 1981, and furnished Forms W-4 to his employers claiming either more exemptions than those to which he was entitled or that he was exempt from withholding entirely.

The petitioner is a tax protestor. In his notice of deficiency, the Commissioner determined that the petitioner received wages and other taxable income of $17,666.00 in 1980 and $24,543.00 in 1981. In addition, he determined that the petitioner was liable for the addition to tax for failure to file under section 6651(a), the addition for underpayment of tax due to negligence or the intentional disregard of rules and regulations under section 6653(a), and the addition for underpayment of estimated taxes under section 6654(a).

OPINION

The first issue for decision is whether the petitioner is liable for the deficiencies as determined by the Commissioner. The Commissioner's determination of a deficiency is presumed correct, and the burden of proving it erroneous is on the petitioner. Rule 142(a), Tax Court Rules of Practice and Procedure[3]; Welch v. Helvering, 290 U.S. 111, 115 (1933). The petitioner has introduced no credible evidence on this issue. In his petition, Mr. Rybecki claimed he had sufficient documentary evidence to prove a lesser amount of gross income and additional deductions. However, the petitioner has failed to introduce any evidence to support his claim and has instead asserted typical tax protestor arguments that wages are not taxable income. Such arguments have been thoroughly considered and rejected by the courts. See United States v. Buras, 633 F.2d 1356 (9th Cir. 1980); Rowlee v. Commissioner, 80 T.C. 1111 (1983), and cases cited therein. Consequently, we hold that the petitioner is liable for the deficiencies determined by the Commissioner.

The second issue for decision is whether the petitioner is liable for the additions to tax under section 6651(a) for failure to file timely returns for 1980 and 1981. The resolution of this issue turns on whether the petitioner has shown that his failure to file was due to reasonable cause and not willful neglect. Sec. 6651(a)(1); Abramo v. Commissioner, 78 T.C. 154, 163 (1982). He has failed to introduce any evidence to show us that such failure was due to reasonable cause. Therefore, he is liable for the additions to tax under section 6651(a).

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[3] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

The third issue for decision is whether the petitioner is liable for the additions to tax under section 6653(a) for negligence or intentional disregard of rules and regulations. Section 6653(a)(1) provides that, if any part of any underpayment is due to negligence or intentional disregard of rules and regulations, there shall be added to the tax an amount equal to five percent of the underpayment. Section 6653(a)(2) provides that there shall be added to the tax an amount equal to 50 percent of the interest payable under section 6601 with respect to the portion of the underpayment which is attributable to the negligence or intentional disregard of rules and regulations. The petitioner bears the burden of proving that his underpayment was not due to negligence or intentional disregard of rules and regulations. Rule 142(a); Bixby v. Commissioner, 58 T.C. 757 (1972).

The addition to tax under section 6653(a) is not applicable where there exists a "bona fide dispute which presents substantial issues of law and fact." Scott v. Commissioner, 61 T.C. 654, 663 (1974). The petitioner's belief that wages do not constitute taxable income does not qualify as such a dispute. The petitioner has introduced no evidence on this issue and, thus, has failed to satisfy his burden of proof. Accordingly, we hold that the petitioner's underpayments for 1980 and 1981 were entirely due to negligence or intentional disregard of rules and regulations.

The fourth issue for decision is whether the petitioner is liable for the additions to tax under section 6654 for underpayment of estimated taxes. Where a taxpayer fails to make adequate prepayment of his estimated taxes, the provisions of section 6654 are mandatory and are applicable, regardless of any showing of reasonable cause or lack of willful neglect. The record indicates that the petitioner failed to make sufficient prepayments of his estimated taxes, and accordingly, we hold that the petitioner is liable for the additions under section 6654.

The final issue for decision is whether the United States is entitled to an award of damages under section 6673. Section 6673, as applicable to this case, provides:

> Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. * * *

This Court has been faced with numerous cases, such as this one, wherein taxpayers have presented frivolous and groundless arguments asserting that wages are not taxable. Such arguments have been rejected by this and other courts on numerous occasions. See, e.g., United States v. Buras, supra; Rowlee v. Commissioner, 80 T.C. at 1119-1120, and cases cited therein. Moreover, it appears that the petitioner was advised that his arguments were frivolous and that if he continued to assert them, he might be liable for damages. Nevertheless, the petitioner has continued to assert frivolous and groundless positions, and based on such positions, he refused to present any evidence or testimony at the trial of his case. The petitioner in this case has abused the processes of this Court and wasted its resources. On the basis of the record, we conclude that the proceedings herein were instituted primarily for delay and that the petitioner's position is both frivolous and groundless. Accordingly, we award damages to the United States under section 6673 in the amount of $2,500.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-324

UNITED STATES TAX COURT

J. MARK KENT and JANICE M. KENT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2361-83. Filed July 29, 1986.

Held: Petitioner's attorney's fees, paid for him by persons unknown, is the only unreported income taxable to petitioner as a result of marijuana smuggling operation. Held further, petitioner's attorney's fees are deductible as expenses which arose in connection with an income-producing activity.

Sidney Soltz, for the petitioners.

Theresa E. Mitchell, for the respondent.

G.M.

ORIGINAL

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined a deficiency in the Federal income tax liability of petitioners for the calendar year 1980 in the amount of $301,530 and an addition to tax under section 6653(b)[1] in the amount of $150,765. The deficiency is based upon respondent's contention that petitioner J. Mark Kent (Kent) received unreported income during the year in the amount of $616,740 from marijuana importation. In addition to this alleged unreported income, the issues include whether Mrs. Kent is an innocent spouse and whether Kent must include in his 1980 income the amount of $9,072.58 paid by person or persons unknown on account of his legal fees. This last issue was raised by respondent in his amended answer.[2] As to the increased deficiency, as well as the fraud addition to tax, respondent bears the burden of proof. The issues are largely factual. Respondent has also conceded a portion of the unreported income included in the statutory notice. For convenience, our Findings and Fact and Opinion are combined.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

[2] On April 23, 1986, petitioner filed a Motion for Reconsideration of our original opinion in this case, which was filed April 10, 1986. (Kent v. Commissioner, T.C. Memo. 1986-139.) Petitioner raised for the first time the issue of the deductibility of the legal fees in question as an expense incurred in connection with an income-producing activity. By Order dated July 9, 1986, we granted petitioner's Motion, and withdrew our original opinion in order to address the issue of the deductibility of petitioner's attorney's fees.

Some of the facts have been stipulated and they are so found. At the time of the filing of the petition in this case, petitioners were residents of Titusville, Florida. Kent, at the time of trial, was 56 years old. He is a high school graduate with a few college courses. His major employment prior to 1980 had been at Cape Canaveral, Florida where he had worked as a quality control engineer on the space program for 10 to 12 years. Petitioners have been married for a number of years. In about 1960 Mrs. Kent had a nervous breakdown and since that time she has been under treatment for her emotional condition with continuing medication which prevents her from driving. There is no evidence that Mrs. Kent participated in any fashion in the circumstances leading up to and following the arrest of Kent for possession of marijuana in 1980 or that she knew anything about it until he telephoned her that he was under arrest. Petitioners have lived modestly, with Kent being the sole support for the household. From time to time Kent has owned fishing boats and has operated as a charter boat captain.

In October or November 1979, pursuant to an advertisement placed by Kent in the Wall Street Journal, an individual who identified himself to Kent only as J. Edward (Butch) Johnson (Johnson) requested that Kent undertake to locate a boat suitable for charter boat fishing in the Virgin Islands with Kent to be the captain. Through a Fort Lauderdale yacht broker, Kent located a boat on the West Coast of Florida at Clearwater. After several telephone conversations with Johnson at a Miami, Florida, telephone number and also with an individual identified only as Mike, and after the boat had satisfactorily passed a survey, Kent was authorized to consummate the purchase. Kent had originally been authorized to look for a boat costing approximately $100,000; the boat was actually purchased in December 1979 for $115,140. The down payment in the amount of $10,000 was tendered by the yacht broker who handled the sale to the owner of the boat or perhaps used in whole or in part to pay the brokerage commission on the sale.[3] The balance of the purchase price was paid in the form of a cashier's check issued by Community Bank, Los Angeles, California, for the account of J. Edward Johnson. There is no evidence as to who arranged for the issuance of the cashier's check or how it was transmitted from California to the seller of the yacht in Clearwater, Florida. Kent testified that he had no recollection of how the down payment was paid or who made arrangements for the cashier's check. He further denied furnishing any part of the purchase price himself and we accept his testimony in this respect.

On the day before Christmas 1979, Kent moved the yacht from Clearwater to Fort Lauderdale, Florida, to a yard where the yacht was painted and refurbished. It was then moved to a rented slip behind a house apparently on the intracoastal waterway at or near Fort Lauderdale. While the boat was at the yard being painted and refurbished, and thereafter while at the slip, Mike was on the boat several times. Until some time in February 1980, Kent continued his job at Cape Canaveral, doing the work on the boat on the weekends. All the expenses for the boat were paid by Mike, but no compensation was paid to Kent for his work in acquiring the boat and making it ready for use.

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[3] The yacht broker, a Captain Allen, was not called as a witness. Whether or not he could have added useful facts as to his contact with Johnson is not known.

At some point in February, Kent was informed by Mike that the boat was not to be used for charter purposes but was to be used to smuggle marijuana into the country. Kent was informed that he would be paid $10,000 for operating the boat on a trip to obtain the marijuana. If arrested, Kent was to be furnished counsel.

On March 6, 1980, Mike delivered $5,000 in cash to Kent to be used for emergencies such as to bribe his way out of an arrest or confiscation and, if not so used, to be the initial installment of his compensation. Two other individuals joined Kent on the boat as crew, Joseph Hessman and John Studer. That afternoon Kent took the boat with his two new crewmen offshore to make contact with the ship which brought the marijuana to the unloading point. After being loaded with approximately 5,000 pounds of marijuana, Kent, in accordance with his instructions, stayed off shore until the afternoon of the next day, March 7, 1980. On the way back into port and on the Coral Gables waterway Kent was stopped and boarded by a U.S. Customs Service patrol. Upon finding the marijuana, Kent and his two crewmen were arrested and the boat, all the marijuana, and the $5,000 expense money in Kent's possession were seized. All three individuals were tried for their part in a conspiracy to smuggle marijuana into the country. As the captain of the boat, Kent was in actual possession of both the boat and the marijuana; he was convicted. The two crewmen were acquitted. Kent had in his possession when arrested a small bag with about $100 worth of marijuana which the parties have stipulated belonged to him. The parties have also stipulated that Kent was in possession of the boat and the marijuana. Disputed is whether both the boat and the marijuana were purchased by Kent with his own funds. The statutory notice assumes that the funds used for these purposes, (including the $5,000 in Kent's possession) were acquired by Kent in 1980, presumably from some illegal source such as marijuana smuggling. However, since the boat was purchased and paid for in 1979, respondent has conceded that the alleged unreported 1980 income should be reduced by the sum of $115,140.

Shortly after his arrest a lawyer from Boston, Richard Gargiulo, visited Kent at the Dade County jail, informing him that he (Gargiulo) had been employed to represent Kent. Gargiulo was paid $20,000 for the representation, $9,072.58 of which was received during 1980, and the balance in 1981. Gargiulo testified that Kent did not employ him but, on the grounds of the Fifth Amendment, declined to state who did employ and pay him. Neither Kent nor Mrs. Kent paid any part of Gargiulo's fee. Both Hessman and Studer were called as witnesses, but both declined to testify as to any matters relating to their presence on the boat or their acquaintanceship with Kent on the grounds of the Fifth Amendment.[4]

Respondent's case is predicated on the fact that 4,966 pounds of average-quality marijuana, with a value of $75 per pound, together with $5,000 in cash were in Kent's possession and constitute unreported income because Kent has no known source therefor. Petitioner denies that he provided funds for the purchase of the marijuana or the boat. Respondent's case is supported only by the fact of the possession, evidence that the agreed upon fee of $10,000 was unreasonably low, and the presumption in respondent's favor. Respondent, in our judgment, has selected the wrong individual to tax.

On the whole, we find Kent to be a credible witness. While we believe that Kent should have, and in fact may have, suspected prior to the conversation with Mike in February 1980, that the mission of the boat was smuggling rather than charter fishing, we are convinced that Kent did not supply the money for the boat, was not in contact with the smugglers who were responsible for the off-shore rendezvous, did not pay for the boat or the marijuana, and did not supply the two crewmen. Kent's story is logical and consistent with his background. There is not a shadow of a fact which places Kent in the smuggling business prior to this one episode or in any other criminal activity. No possible source for $600,000 in accumulated income has been suggested. And we doubt, based upon our observation of Kent in the courtroom and on the witness stand, that he has the ability to have made the smuggling arrangements. There is no credible evidence before us to support respondent's theory; it is all to the contrary. The speculation that $10,000 was an unreasonably low fee for Kent's services as boat captain is simply speculation. The only unreported income derived by Kent in 1980 is the attorney's fee of $9,072.58. This sum is taxable to Kent in that year. We conclude, however, that this sum is deductible under section 212.

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[4] A minor legal issue arises out of the refusal to testify by these three witnesses--whether or not any inference for or against Kent can be made as a result of that refusal. Both parties concluded that drawing any inference from this circumstance would impinge on the constitutional protection against self incrimination. Therefore, for purposes of this case, we ignore the fact that these important witnesses declined to provide vital information to the Court. Neither counsel referred to the case of Baxter v. Palmigiano, 425 U.S. 308 (1976), which suggests that, in appropriate circumstances, the fact finder may take into consideration a party's assertion of the Fifth Amendment privilege. The ramifications of that case are unclear. For these reasons, we accept the position of the parties. See 64 Marquette Law Review 243, 256 et seq. (1980), "Daskal, Assertion of the Constitutional Privilege Against Self-Incrimination in Federal Civil Litigation: Rights and Remedies."

Litigation expenses incurred in the defense of criminal charges are deductible when the expenses arise in connection with a taxpayer's income-producing activity whether or not the activity rises to the level of a trade or business. Commissioner v. Tellier, 383 U.S. 687 (1966); Johnson v. Commissioner, 72 T.C. 340 (1979). We find this case indistinguishable from Johnson where we held that the taxpayer's husband's legal expenses stemmed directly from his attempt to obtain income illegally. Johnson v. Commissioner, supra at 348. In the instant case, petitioner was employed to operate a boat used to smuggle marijuana into the country. Petitioner was to be paid $10,000 for his involvement in the marijuana smuggling operation. As a result of his operation of the boat, petitioner was arrested and charged with criminal offenses. While petitioner may not have been in the business of smuggling, he was engaged in an activity entered into for profit. His legal expenses arose as a direct result of that activity.[5] Thus, following our holding in Johnson, petitioner's legal expenses are appropriately deductible under section 212.[6]

With respect to the addition to tax for fraud under section 6653(b), there is no deficiency in income tax and hence nothing to which this addition could apply. Similarly, because we find that the only unreported income for the year 1980 is subject to a corresponding deduction, we do not need to address Mrs. Kent's innocent-spouse arguments.

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[5] Because we hold that petitioner's expenses are deductible under section 212, we need not address respondent's argument that the legal fees were a personal expense even if petitioner's conviction was potentially detrimental to his business activities as a charter boat captain.

[6] Without commenting on its applicability to this case, we note that section 280E provides that, with respect to amounts paid or incurred after September 3, 1982 [in tax years ending after such date], no deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances which is prohibited by Federal law or the law of any state in which such trade or business is conducted.

Decision will be entered
for petitioner.

JU 11.7/2: 1986-325

COMPLETED

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T. C. Memo. 1986-325

MF 204

UNITED STATES TAX COURT

KLOPPENBERG AND COMPANY, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 14926-83, 14927-83, 14928-83, 14929-83, 14930-83, 14931-83, 14932-83, 14933-83, 14934-83. Filed July 29, 1986.

Held: Respondent's motions to amend the pleadings denied; individual petitioners received constructive dividends as a result of sale of property interest between related corporations; disallowance of portion of corporate petitioner's interest deduction sustained; individual petitioners did not realize ordinary income on sale of depreciable asset between related corporations; and assessment of deficiencies was not barred by statute of limitations.

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[1] The following cases were consolidated for trial, briefing, and opinion: George A. Kloppenberg and Zona B. Kloppenberg, Docket No. 14927-83; George F. Kloppenberg and Helen S. Kloppenberg, Docket No. 14928-83; Joseph R. Kloppenberg and Mary C. Kloppenberg, Docket No. 14929-83; James T. Kloppenberg and Mary C. Kloppenberg, Docket No. 14930-83; Laura A. Kloppenberg, Docket No. 14931-83; Christine A. Kloppenberg, Docket No. 14932-83; Brian A. Kloppenberg, Docket No. 14933-83; and Paul A. Kloppenberg, Docket No. 14934-83.

G. M.

ORIGINAL

Melvin A. Coffee and Theodore H. Merriam, for the petitioners.

Mark H. Howard and Christopher L. Neal, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined deficiencies in petitioner Kloppenberg and Company's Federal income taxes for the years ending January 31, 1979 and January 31, 1980 of $10,883 and $13,053, respectively. Respondent also determined deficiencies in the individual petitioners' Federal income taxes as follows:

Petitioner(s)	1978	1979
George A. and Zona B. Kloppenberg	$23,654	$ 3,188
George F. and Helen S. Kloppenberg	$ 6,222	$ 337
Joseph R. and Mary C. Kloppenberg	$ 9,544	$ 810
James T. and Mary C. Kloppenberg	$ 4,828	$ 808
Laura A. Kloppenberg[2]	$ 286	$ 16
Christine A. Kloppenberg[2]	$ 286	$ 16
Brian A. Kloppenberg[2]	$ 286	$ 16
Paul A. Kloppenberg[2]	$ 286	$ 16

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[2] Laura A., Christine A., Brian A. and Paul A. Kloppenberg, all of whom were minors in 1978, are petitioners herein solely because their father, petitioner George F. Kloppenberg, made a gift of 6 shares of GAZB stock to each prior to the challenged transaction.

Explanation of Issues

The issues in this case arise out of a multi-step transaction involving two corporations (Kloppenberg and Company (Kloppenberg Co.) and G.A.Z.B. Corporation (GAZB)) and the G.A.Z.B. Trust (Trust), all of which were owned by some or all of the individual petitioners prior to May 3, 1978, and Tejon General Partnership (TGP), an unrelated entity. As structured by the Kloppenbergs and the principals of TGP, the May 3, 1978 transaction occurred as follows: (1) the shareholders of GAZB transferred all of their stock in GAZB to the Trust; (2) the Trust sold all of the GAZB stock to TGP; (3) GAZB was immediately liquidated and its assets, which were principally three parcels of real estate, viz the Oxford, the Elati, and the Tejon properties, were distributed to TGP; (4) TGP sold its interest in the Oxford property to Kloppenberg Co. for $1 million.[3] Kloppenberg Co. had been the sole tenant of the Oxford property for some years.

Respondent determined that, in contrast to its form, the substance of the portion of the transaction relating to the Oxford property was a sale of an interest in that property at a price in excess of fair market value by GAZB to Kloppenberg Co. with a subsequent distribution of sale proceeds to the shareholders of GAZB. According to respondent, TGP's role was that of a conduit or "straw man" for the multi-step transaction as far as the interest in the Oxford property is concerned. Based on respondent's pre-trial position, the issues for decision are:[4]

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[3] TGP acquired the Oxford property burdened by the outstanding lease to Kloppenberg Co. On acquisition by the latter the leasehold interest merged with the interest subject to the lease with the result that Kloppenberg Co. then owned the fee simple interest.

(1) Whether Kloppenberg Co. purchased an interest in the Oxford property at a price in excess of its fair market value;

(2) if (1), whether the individual petitioners received constructive dividends from Kloppenberg Co. as a result of the purchase of the Oxford property interest;

(3) if (2), whether the interest deductions flowing from the May 3, 1978, transaction claimed by Kloppenberg Co. must be decreased as a consequence of the constructive dividends;

(4) whether the individual petitioners received ordinary income pursuant to section 1239[5] on the transfer of GAZB's interest in the Oxford property, a depreciable asset, to Kloppenberg Co.; and

(5) whether assessment of deficiencies as to Kloppenberg Co. for the year ending January 31, 1979, and the individual petitioners for 1978 is barred by the running of the applicable statute of limitations.

On brief, respondent requests that the Court allow him to amend the pleadings in a number of respects which requests will be addressed in the opinion portion of this report. The most significant of these requested amendments is consideration of a different "form" of the challenged transaction, i.e., a distribution of the interest in the Oxford property by GAZB or the Trust to the shareholders/beneficiaries followed by a sale of the Oxford property to Kloppenberg Co. Based on this reformulation, respondent asserts that the individual petitioners also received constructive dividends from GAZB.

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[4] Respondent concedes that Kloppenberg Co. is entitled to additional depreciation deductions as a result of the May 3, 1978 transaction for that portion of the purchase price allocable to the Oxford building. The parties have not, however, agreed on the amount of these additional deductions.

[5] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and exhibits are incorporated herein by this reference. Kloppenberg Co.'s principal place of business at the time its petition was filed was Englewood, Colorado. The individual petitioners were all residents of Colorado at the time their respective petitions were filed.

The Kloppenberg Family Corporations

Kloppenberg Co. manufactures ice machines and is a custom fabricator of stainless steel food service equipment. During the years in issue Kloppenberg Co.'s plant and offices were located in a building specifically built for the company on the Oxford property.

In April 1978, the stock of Kloppenberg Co. was owned by petitioners George A. and Zona B. Kloppenberg and their sons (referred to collectively as the Kloppenberg Family) as follows:

Petitioner	Ownership Percentage
George A. Kloppenberg	35
Zona B. Kloppenberg	35
George F. Kloppenberg	10
Joseph R. Kloppenberg	10
James T. Kloppenberg	10

In addition to their status as shareholders, with the exception of Joseph R. Kloppenberg who was a consultant to the Board of Directors, each member of the Kloppenberg Family was a director and officer of Kloppenberg Co. in April 1978. Kloppenberg Co.'s retained earnings and profits on May 3, 1978, the date of the challenged transaction, were in excess of $473,000.

In 1978 GAZB's only business was holding the Oxford property and properties located on Elati Street (the Elati property) and Tejon Street (the Tejon property) and collecting rents thereon. The retained earnings of GAZB shown on the final return filed for the period ended May 3, 1978, were $173,119.

On April 25, 1978, George F. Kloppenberg transferred six shares of his GAZB stock to each of his four minor children under the Colorado Uniform Gifts to Minors Act.[6] As of that date, the shares of the GAZB stock were held as follows:

Petitioner	Number of Shares
George A. Kloppenberg	95
Zona B. Kloppenberg	95
George F. Kloppenberg	36
Joseph R. Kloppenberg	60
James T. Kloppenberg	60
Christine A. Kloppenberg	6
Paul A. Kloppenberg	6
Brian A. Kloppenberg	6
Laura A. Kloppenberg	6

With the exception of the children, each shareholder was a director and officer of GAZB.

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[6] These stock transfers were made to George F. Kloppenberg as custodian for each child.

The Oxford Property

In 1966, GAZB acquired the land on West Oxford Street at a cost of $50,111. On September 8, 1966, a net ground lease was executed between GAZB and Kloppenberg Co. The lease term was 30 years and the rent was $12,000 per year payable on a monthly basis. Pursuant to the terms of the lease, Kloppenberg Co. was required to erect a building on the Oxford property in accordance with a previously approved plan[7] at a cost of not less than $430,000. At the expiration of the lease, the building would be surrendered to GAZB. The lease specifically provided that "the covenants, stipulations, and conditions herein contained shall inure to the benefit of and shall be binding upon the successors and assigns of the lessor and the successors and assigns of the lessee."

On November 10, 1966, Kloppenberg Co. entered into construction and permanent financing agreements with the Engelwood State Bank concerning construction of the building on the Oxford property. The loan was in the amount of $310,000 and was for a term of 15 years. As security for this loan,

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[7] The Oxford building was designed to maximize the efficiency of the Kloppenberg Co. manufacturing operation. It had a reinforced heavy duty floor which was "dead level" to facilitate the manufacture of cafeteria counters and other flat metal surfaces. Other features of the building include extensive electrical wiring throughout and a heavy duty roof and suspension system which supports a monorail-type crane with a power lift. The building was designed with expansion joints so that future expansion could be easily accomplished and integrated with the existing building. During construction, caissons going 20 feet into the ground were placed every 10 feet in that portion of the building located over a previously filled dump site. Although these features increase the value of the Oxford property to Kloppenberg Co., they did not increase its fair market value.

Kloppenberg Co. delivered to the Bank a promissory note which was secured by a deed of trust on the Oxford property executed by GAZB and Kloppenberg Co. To provide additional security for payment of the note, GAZB assigned to the Bank its lease agreement with Kloppenberg Co. In fact, the lease agreement had originally been executed because the Bank required a written lease before it would provide the construction financing. The Bank loan was paid in full on January 31, 1972 and shortly thereafter the Bank released all collateral on the loan. During the years in issue, Kloppenberg Co. claimed depreciation for the building on its Federal corporate income tax returns.

As noted above, the rent specified in the lease was $1,000 per month. However, at a special meeting of the Board of Directors of Kloppenberg Co. on April 17, 1974, George A. Kloppenberg, the president of both GAZB and Kloppenberg Co., recommended increasing the rent to $1,500 per month, retroactive to April 1, 1974. A motion to this effect was unanimously approved and, thereafter, Kloppenberg Co. paid this increased rent. The lease agreement was not amended to reflect this increased rent.

Four appraisals of the Oxford property were received in evidence. Each appraisal valued the property as of May 3, 1978. The first appraisal is a September 23, 1980 Engineer Memorandum Report prepared by Eddie T. Fernandez, an engineer in respondent's employ. Based on an assumed fee simple fair market value of $442,000, Mr. Fernandez concluded that the fair market value of the Oxford property subject to the leasehold interest held by Kloppenberg Co. was $300,000.

The second appraisal, obtained by petitioner Kloppenberg Co., is dated November 29, 1980, and was prepared by Watson A. Bowes. This appraisal was based on the assumption that the property was "free and clear" of all encumbrances, i.e., Mr. Bowes did not consider the outstanding leasehold interest of Kloppenberg Co. Using three methods of appraisal, Mr. Bowes concluded that the value of Oxford property was $1,940,000.

Apparently in response to petitioners' appraisal, Mr. Fernandez prepared a supplemental Engineer Memorandum Report dated February 12, 1981. The same method of valuation[8] and rental of $18,000 per year as in the original report were used. However, Mr. Fernandez used a lower discount rate of 9.25 percent. Based on the unencumbered fee interest value determined by petitioners' appraiser of $1,940,000, with which he agreed, Mr. Fernandez reached a revised value for the fee interest subject to the outstanding leasehold interest of $527,000. Of this value, $273,000 was allocable to the land and $254,000 to the building. The fair market values found by Mr. Fernandez in this appraisal were adopted by respondent in the notices of deficiencies.

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[8] The method used consisted of capitalizing the present worth of the anticipated net income before recapture for the remaining term of the lease and valuing GAZB's reversion interest in the land and building by discounting its anticipated value to its present worth.

In preparing for trial, respondent obtained a third appraisal of the Oxford property by Peter D. Bowes and Brooke B. Leer (Trial Appraisal). Based on sales of comparable properties, the Trial Appraisal concluded that the fair market value of the unencumbered fee interest in the Oxford property was $1,700,000 and the fair market value of the interest subject to the lease was $650,000 or in a range of value of $526,426 to $710,068. The range of values was computed using discount rates of 6.5 percent and 8.5 percent. The Trial Appraisal was based on rent of $1,500 per month.

Pre-Transaction Discussions Concerning GAZB

During 1976 and 1977, the shareholders/directors of GAZB engaged in numerous discussions concerning the possibility of a liquidation or dissolution of GAZB. In considering these options, the Kloppenberg Family always intended that the Oxford property would be transferred to Kloppenberg Co.

As early as June 26, 1976, the shareholders/directors of GAZB had "approved the principle of liquidation" and were giving this possibility serious consideration. On December 17, 1977, a plan to liquidate GAZB was approved at a special directors' meeting. This plan was to become effective only upon the vote of at least two-thirds of the outstanding shares of the corporation at a special shareholders' meeting scheduled for February 1, 1978. The plan of liquidation adopted by the Board of Directors was never voted on or adopted by the shareholders. However, in contemplation of adoption of the plan, Forms 964 (Election of

Shareholder under Section 333 Liquidation) were signed by each shareholder and Form 966 (Corporate Dissolution or Liquidation) was signed by George A. Kloppenberg on behalf of GAZB. These forms were retained in the files of GAZB's accountant but, since no liquidation occurred, were never filed with the Internal Revenue Service.[9] Prior to the challenged May 3, 1978, transaction, no GAZB liquidation occurred nor were any assets of GAZB distributed to the individual petitioners.

Negotiations Preceding the May 3, 1978 Transaction

In October 1977, GAZB was approached by Terrance L. Schmidt with an offer to purchase the Tejon property. At that time, Schmidt and Jonathan E. Sharp were negotiating to purchase the Rose Manufacturing Company (Rose) and needed a building in which to relocate that business. Schmidt's offer of $475,000 for the Tejon property was refused.

As Schmidt was unable to negotiate a quick purchase of the Tejon property, Rose entered a lease for this property effective December 1, 1977. The lease term was 7 years with an option in Rose to extend the term for 3 years. Rose also obtained a right of first refusal if GAZB elected to sell the Tejon property and received a third party offer. This right of first refusal did not apply if GAZB elected to dissolve and assign its interest to its shareholders.[10] After the lease was executed, Schmidt continued to negotiate with the directors of GAZB for the purchase of the Tejon property. A major difficulty in these negotiations involved the tax liability that would be incurred by GAZB and its shareholders as a result of such a sale. An impasse in negotiations was reached in March 1978.

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[9] Respondent asserts that the fact that the forms were signed under penalty of perjury constitutes some sort of conclusive presumption that the plan was adopted. It is clear from the record that such a presumption is contrary to fact. Further, it is irrelevant that the forms were signed under penalty of perjury as they were never carried into effect by delivery.

The May 3, 1978 Transaction

As a final proposal, Schmidt suggested that Tejon General Partnership (TGP)[11], a partnership the shareholders of Rose controlled, acquire the stock of GAZB, immediately thereafter liquidate the corporation and sell the Oxford property to Kloppenberg Co. In considering this proposal, neither party contemplated that the partnership would retain the Oxford property. In fact, transfer of the Oxford property interest to Kloppenberg Co. was understood as a condition of any sale of the GAZB stock to TGP. Schmidt's proposal met the primary objectives of both parties--the principals of Rose would acquire the Tejon property and the Kloppenberg Family would retain ownership of the

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[10] Before entering this lease, George A. Kloppenberg checked on the financial status of Rose via inquiries to its bank and a visit to Rose's premises. He also obtained Rose's financial statements when the lease was executed. Similarly, prior to entering the lease, Schmidt investigated the background, financial capacity, and reputation of the Kloppenbergs. The record does not indicate the extent of Schmidt's investigation. No supplemental investigation was done by either party concerning the other prior to the challenged transaction.

[11] TGP was formed by Schmidt, Sharp and members of their families in March 1978. Schmidt was the managing partner of TGP.

Oxford property without incurring certain taxes. The transaction, as proposed by Schmidt, was consummated on May 3, 1978.[12]

On May 3, 1978, all of the stock of GAZB was transferred to a newly formed G.A.Z.B. Trust (Trust). George A. Kloppenberg was designated the managing trustee of said Trust. Each GAZB shareholder received a beneficial interest in the Trust corresponding to his/her prior ownership of GAZB stock.

Before acquiring GAZB's stock on May 3, 1978, TGP entered an option contract to sell the Oxford property interest it would acquire to Kloppenberg Co. The option contract states that: "WHEREAS, Tejon intends to purchase G.A.Z.B. Corporation; and WHEREAS, Kloppenberg desires to purchase and Tejon desires to sell the herein described real estate," if TGP acquired GAZB's stock it would liquidate the corporation and sell the Oxford property, subject to the existing lease, to Kloppenberg Co. for $1 million.[13]

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[12] The transaction was initially scheduled to be consummated on May 1, 1978 and some documents executed by the parties bear that date. It is clear from the record, however, that all of the relevant documents were executed on May 3, 1978.

[13] A similar option contract had been entered by TGP with an unrelated party on April 4, 1978, concerning the Elati property with a stated purchase price of $50,000. This option contract was relatively unimportant to the transaction between TGP and the Trust. As Schmidt stated, if such contract had not existed on May 3, 1978, TGP "could have found some way to use the property or sell it or lease it."

To effectuate the sale to TGP, an "Agreement to Purchase Stock" was executed by TGP and the Trust. TGP paid $1,603,600 for all of GAZB's stock. The majority of the purchase price was allocated to the three properties owned by GAZB as follows:[14]

Oxford Property	$1,000,000
Tejon Property	500,000
Elati Property	50,000

Correspondence from TGP's to GAZB's attorney dated April 12, 1978, indicates that the parties had agreed that the $500,000 allocated to the Tejon property and the $50,000 allocated to the Elati property reflected the fair market values of those properties. However, as of that date, the purchase price for the interest in the Oxford property had not been determined. The $1 million subsequently agreed to for this interest was calculated by the accountant for the Kloppenberg family and their controlled corporations. Despite the fact that in the "Agreement to Purchase Stock" the Trust warranted that GAZB owned the Oxford property "in fee simple * * * subject to the existing leases," this calculation was based on an unencumbered fee interest in the Oxford property, i.e., the impact on value of the lease between GAZB and Kloppenberg Co. was not considered. Nor was any special use value the Oxford property may have to Kloppenberg Co. considered. In agreeing to the $1,000,000 value, TGP's principal concern was that its security interest in the property be adequate in relation to the Installment Note from Kloppenberg Co. to TGP.

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[14] The balance of the purchase price was allocable to accounts receivable and cash.

On May 3, 1978, TGP paid the Trust $185,000 in cash and executed four Installment Notes, three of which were secured by Deeds of Trust on specific properties as follows:[15]

Note Principal Amount	Securing Asset
$900,000	Oxford Property
450,000	Tejon Property
45,000	Elati Property

The notes from TGP to the Trust were secured by GAZB's underlying assets rather than the stock as the corporation was to be immediately liquidated.

The $900,000 Installment Note secured by the Oxford property was payable as follows: (1) $100,000 plus $6,562.50 interest payable on June 3, 1978; (2) $100,000 plus $5,833.33 interest payable July 3, 1978; and (3) $700,000 principal, plus interest, payable in 238 equal monthly installments. The Note specifically provided that there would be no prepayment before February 1, 1979.

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[15] Although the fourth note, in the amount of $23,600, was not specifically secured by the accounts receivable, as payment was received on any account receivable, an immediate and corresponding payment by TGP to the Trust was required. Further, this note was payable within 3 months and the Trust warranted that the accounts receivable were collectible within 3 months and that, on breach of any warranty, TGP was entitled to a dollar-for-dollar reduction in or offset against the purchase price or outstanding balance of any note. Consequently, TGP's only risk on this note was the difference between its interest on the note to the Trust (8-3/4 percent) and the interest on the accounts receivable which were warranted to bear interest at "no less than 6 percent." This note was paid in full on June 5, 1978.

To effectuate the liquidation of GAZB the following steps were taken: (1) the Kloppenberg Family directors of GAZB resigned; (2) Schmidt, Jonathan E. Sharp and Jon C. Sharp were elected directors of GAZB; and (3) a plan of complete liquidation and distribution of all property was adopted at a special joint meeting of the new shareholders and directors of GAZB. The minutes of this May 3, 1978 meeting state:

> [the President, Jonathan E. Sharp] reported that certain lessees had inquired about the possibility of purchasing their leased premises, that the Corporation had refrained from any negotiations to that end, and that there were no outstanding commitments to sell binding on the Corporation. The President further advised that the new, sole shareholder [TGP] had entered into negotiations with the lessees prior to becoming a shareholder and had entered into several agreements relating to the purchase of the land, which agreements were to be effective if and only if the current shareholder did, in fact, acquire control of this Corporation.

Upon liquidation of GAZB, appropriate Deeds of Trust were executed by Jonathan E. Sharp on behalf of GAZB to convey the property owned by the corporation to TGP.

To transfer TGP's interest in the Oxford property to Kloppenberg Co. an "Agreement to Purchase Real Estate" was also executed on May 3, 1978. The purchase price was $1,000,000, identical to that portion of TGP's purchase price for the GAZB stock allocated to the Oxford property. The terms of payment were $100,000 cash and execution of a $900,000 Installment Note. With the exception of the maker and payee, the terms of this Note were identical to the $900,000 Note between TGP and the Trust. The "Agreement to Purchase Real Estate" required that TGP provide evidence of a reduction in the outstanding first mortgage on the Oxford property within 10 days of any principal payment by Kloppenberg Co.

Kloppenberg Co. received from TGP a Deed for the Oxford property which was "subject to [the] first Deed of Trust securing G.A.Z.B. Trust, and subject to [the] existing lease to Kloppenberg and Company." In contrast, the Deed of Trust given by Kloppenberg Co. to TGP to secure its $900,000 Note was for the unencumbered fee simple interest[16] in the Oxford property "except [for] the First Deed of Trust given by Tejon General Partnership to G.A.Z.B. Trust."

Of the $1,603,600 purchase price for the GAZB stock paid by TGP, $1,562,256 or 97.42 percent represents gain. As principal payments of $419,710 were received in 1978, the Trust return for that year reports $408,881 of that amount as capital gain. In 1979, the Trust return reflects receipt of $23,693 of what are characterized as capital gains. In both years, these amounts, as well as the interest payments made by TGP, were, after deduction of expenses, distributed in full to the trust beneficiaries.

In the notices of deficiencies, respondent determined that the fair market value of the Oxford property interest purchased by Kloppenberg Co. on May 3, 1978, was $527,000 and that the $473,000 excess purchase price constituted constructive dividends to the individual petitioners from Kloppenberg Co. Consequently, respondent increased their ordinary income and decreased their reported capital gains. As a consequence of this recharacterization, respondent disallowed a portion of the interest deduction claimed by Kloppenberg Co. asserting that a deduction for interest on the constructive dividends was not allowable. Respondent also determined that, in substance, members of the Kloppenberg Family had sold a depreciable asset to Kloppenberg Co. and, therefore, the individual petitioners must recognize ordinary income pursuant to section 1239.

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[16] As Kloppenberg Co. held the leasehold interest in the Oxford property prior to May 3, 1978, when it acquired the fee interest subject to said leasehold the doctrine of merger of title applied and it held a fee simple interest in said property.

Statute of Limitations Issue

Kloppenberg Co. and each of the individual petitioners timely filed their Federal income tax returns for the years in issue. Forms 872-A (Special Consent[s] to Extend the Time to Assess Tax) were timely executed by or on behalf of Kloppenberg Co. for its tax year ending January 31, 1979, and each individual petitioner for 1978. Each of these provided that the agreed to extension could be terminated by receipt of a Form 872-T (Notice of Termination of Special Consent to Extend the Time to Assess Tax) from the taxpayer or mailing of such Form 872-T or a notice of deficiency by the Internal Revenue Service.

By letter dated July 21, 1982, to respondent, petitioners' counsel sought to verify his understanding of a July 20 telephone conversation concerning Kloppenberg Co. and related taxpayers in which he stated:

> It is my understanding that you will forward the case for issuance of a 90-day letter based on a partial agreement. You have agreed to concede the accumulated earnings tax issue and there has been no resolution to

> the real estate issue. We understand that the taxpayers will be receiving statutory notices of deficiencies within the next 60 days.

Notices of deficiencies were mailed to petitioners on March 15, 1983.[17] No Form 872-T was mailed or received by respondent prior to mailing by respondent of these notices of deficiencies.

OPINION

Respondent's Motions to Amend

As a preliminary matter, we must dispose of respondent's requests that he be allowed to amend the pleadings in four respects.[18] These requests were made for the first time in respondent's brief. Generally, issues raised at such a late date are not considered properly before the Court. Church of Scientology v. Commissioner, 83 T.C. 381, 524-525 (1984); Aero Rental v. Commissioner, 64 T.C. 331, 338 (1975); Markwardt v. Commissioner, 64 T.C. 989, 997 (1975). However, Rule 41(a) provides that the Court, in its discretion, may grant motions to amend at any time if "justice so requires," i.e., if granting said motions will not result in surprise and substantial detriment/prejudice, to petitioners. Johnsen v. Commissioner, 83 T.C. 103 (1984); Estate of Horvath v. Commissioner, 59 T.C. 551, 555 (1973).

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[17] A notice of deficiency which was identical, except for the address, was sent to petitioners James T. and Mary C. Kloppenberg on April 11, 1983.

[18] Respondent miscasts his motions as requests to amend the pleadings to conform to the evidence pursuant to Rule 41(b). This subsection is inapplicable as none of the requested amendments constitute issues tried by express or implied consent nor was evidence received over an objection that it was not within the ambit of the issues raised by the pleadings. Therefore, respondent's motions will be considered as made pursuant to Rule 41(a). A motion pursuant to that rule requires that the "motion for leave to amend a pleading shall state the reasons for the amendment and shall be accompanied by the proposed amendment." Respondent has failed to meet this requirement choosing instead to merely request such amendments on brief.

The first amendment respondent requests is that the constructive dividend income allocated to the children of George F. Kloppenberg in the notices of deficiencies be reallocated to the remaining individual petitioners. This request is premised on respondent's late realization that these minors were not shareholders of Kloppenberg Co. and "[t]o be technically correct, the distributions from Kloppenberg and Company should be treated as dividends only to the stockholders of Kloppenberg and Company." [19] Consideration of this issue would clearly prejudice the individual petitioners whose income respondent seeks to increase. Therefore, we deny respondent's request to amend the pleadings to consider this issue.[20]

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[19] Correct allocation of the constructive dividend is complicated here because the shareholdings in GAZB were not in the same proportions as those in Kloppenberg Co., even ignoring the transfer to the four children of George F. Kloppenberg. Respondent has cited no precedent for his requested reallocation. A reallocation to George F. Kloppenberg alone might have merit given his gift to his children shortly before the May 3, 1978, transaction. However, respondent has not advocated this singular reallocation and, therefore, we need not consider it.

[20] As respondent has conceded that individual petitioners Laura A., Christine A., Brian A., and Paul A. Kloppenberg could not receive constructive dividends from Kloppenberg Co. since they were never shareholders of that corporation. We must hold for these petitioners on the issue of constructive dividends from Kloppenberg Co.

As a second amendment, respondent requests that the Court find that there was a constructive dividend of $173,119 from GAZB to the individual petitioners through the Trust. Respondent's counsel misstates the record in arguing that during trial he specifically requested an opportunity to amend the pleadings in this regard. During trial respondent's counsel stated that, if after an examination of the documents and facts it is established the transaction should be recast in a "slightly different manner," he requested "that the pleadings be allowed to be amended to conform to that proof to that extent dealing solely with this dividend issue from Kloppenberg and Company raised by the statutory notice."[21] No mention was made of dividends from GAZB. In fact, prior to receipt of respondent's brief, neither the Court nor petitioners had any indication that respondent would seek to recharacterize a portion of the proceeds attributable to the Oxford property as constructive dividends from GAZB. To require petitioners to respond to this allegation would result in substantial prejudice to them. Therefore, respondent's request to amend the pleadings to assert that petitioners received constructive dividends from GAZB is denied.

Respondent also requests that two amendments be made to the pleadings regarding the application of section 1239: (1) that the value placed on the depreciable remainder interest be increased; and (2) that petitioners' use of the installment method of reporting gain in the section 1239 context be disallowed. As to the value attributed to the depreciable remainder interest, consideration of an increased value will not result in surprise or unfair prejudice to petitioners. Although we have considered this contention, respondent has failed to carry his burden of proving that the value of depreciable remainder interest in the Oxford property is greater than that set forth in the notices of deficiencies.

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[21] Although we choose not to do so, respondent's counsel's statements could be taken as "the equivalent of a stipulation." Church of Scientology v. Commissioner, 83 T.C. 381, 524 (1984).

Respondent's request to place in issue petitioners' use of the installment method must be denied. Disallowance of installment gain reporting would clearly be prejudicial to petitioners as they were not afforded an opportunity to present evidence or arguments on this issue. Consequently, we deny respondent's motion to amend the pleadings to raise this issue.[22]

Valuation of the Oxford Property Interest

Having disposed of respondent's requests to amend the pleadings, we now turn to the parties' substantive disputes.[23]

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[22] During trial, the Court commented on an alternative structure of the transaction which might have accomplished petitioners' objectives. Respondent misconstrues this speculation as an alternative method of analysis proposed by the Court. This alternative would result in the disallowance of installment reporting by petitioners. However, neither petitioner nor respondent has argued for adoption of this analysis. Consequently, we need not consider respondent's "courtesy" argument concerning this alternative.

[23] On brief respondent states that "[o]ther issues related to the remaining useful life of the remainder interest in the Oxford property building and the appropriate depreciation method were not presented to the Court during trial. These issues could potentially be resolved through use of Tax Court Rule 155." The
(footnote continued)

Initially, we must determine the value of the Oxford property interest acquired by Kloppenberg Co. on May 3, 1978. A determination that Kloppenberg Co. paid no more than the fair market value for this interest would effectively dispose of respondent's determinations that the individual petitioners received constructive dividends from Kloppenberg Co. and that a portion of Kloppenberg Co.'s interest deduction should be disallowed. Petitioners assert that the fair market value of the interest in the Oxford property in issue on May 3, 1978, was $1 million. In contrast, respondent determined in the notices of deficiencies that the fair market value of this interest was $527,000.

The determination of fair market value is a question of fact. Kaplan v. Commissioner, 43 T.C. 663, 665 (1965). Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U.S. 546, 551 (1973). Petitioners have the burden of proving that respondent's determination of fair market value is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). They have failed to carry this burden.

(footnote continued from previous page)
useful life and depreciation method used by petitioners were not challenged by respondent before or during trial. Just as issues raised for the first time on brief are not properly before the Court, new issues or matters not presented during trial will not be considered in a Rule 155 computation. Rule 155(c). Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); Cloes v. Commissioner, 79 T.C. 933 (1982).

In challenging respondent's valuation, petitioners assert that the $1 million value allocated to the Oxford property interest in the transfers between the Trust and TGP and Kloppenberg Co. and TGP represents the product of arm's-length negotiations and, therefore, is the most probative evidence of fair market value. While "a normal attribute of a true arm's-length sale is a purchase price at least approximately equal to fair market value," Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1240-1241 (1981), the mere fact that a $1 million purchase price was agreed to between unrelated parties does not, in and of itself, indicate that said price is the result of arm's length negotiations. While negotiations leading up to the challenged transaction occurred over a period of approximately 4 months, the valuation of the Oxford property was not a focus of these negotiations. In fact, it appears that neither Schmidt nor TGP were particularly concerned with the value attributed to the Oxford property so long as TGP obtained adequate security from Kloppenberg Co. for its $900,000 note. The security TGP obtained for this note was a deed of trust encompassing a fee simple interest in the Oxford property. The parties are in accord that said interest had a fair market value well in excess of $1 million. Consequently, TGP assumed no risk that Kloppenberg Co. would fail to make payments on its note and had little incentive to negotiate with respect to the value allocated to a lesser interest in the Oxford property. Similarly, the Kloppenberg Co. shareholders assumed no risk that TGP would benefit from an excessive price as TGP was required to make corresponding payments to the Trust any time it received principal payments from Kloppenberg Co. Neither the portion of the stock purchase price allocated to the Oxford property interest nor the agreed to purchase price paid by Kloppenberg Co. was the result of arm's-length negotiations. See Goldstein v. Commissioner, T.C. Memo. 1960-276, affd. 298 F.2d 562 (9th Cir. 1962). Consequently, we must independently seek to determine the fair market value of the Oxford property interest in issue.

Petitioners submitted one appraisal of the Oxford property. This appraisal is of no value to the Court as it values the fee simple interest in the Oxford property rather than the interest Kloppenberg Co. acquired on May 3, 1978. Petitioners' argument that the lease between GAZB and Kloppenberg Co. should be disregarded in valuing the Oxford property interest is meritless. No one disputes that after May 3, 1978, Kloppenberg Co. owned the Oxford property in fee simple. However, petitioners' argument that the lease should therefore be disregarded ignores the fact that Kloppenberg Co. owned a significant interest in the Oxford property prior to the challenged transaction. It is not the value of the combined interest which Kloppenberg Co. owned after May 3, 1978, which is in issue. Rather, it is the interest which Kloppenberg Co. purchased from TGP on that date, i.e., a fee simple interest subject to the outstanding lease. Similarly, petitioners' arguments that the written lease was entered solely at the Bank's insistence and that after the Bank loan was paid off the Kloppenberg Family believed the lease had no effect are irrelevant. While the Bank loan may have been the precipitating factor in executing a written lease between Kloppenberg Co. and GAZB, the loan and the lease were not interdependent. Petitioners' assertion that after the Bank loan was paid off the lease had no effect is contrary to fact. Kloppenberg Co. continued to claim depreciation deductions for the Oxford building thereby recognizing its continuing interest in the Oxford property. Similarly, in the May 3, 1978, transaction documents, descriptions of the Oxford property explicitly referenced the leasehold interest held by Kloppenberg Co.

Respondent's determination that the fair market value of the relevant Oxford property interest was $527,000 is presumed correct and is supported by the February 12, 1981, appraisal of Mr. Fernandez and the Trial Appraisal. Petitioners seek to discredit these appraisals arguing that they are based on the faulty assumption that the buyer of the Oxford property interest from TGP would be bound by the lease. This assumption is not false. Since the purchaser of the property was Kloppenberg Co., the existing lessee, there was a merger of the leasehold and the fee subject to the lease, effectively cancelling the lease. This is a result of the two interests being held by the same person. It does not mean that the leasehold estate should be ignored in the valuation. The standard for determining fair market value is not an exceptional purchaser with a pre-existing interest in the property to be valued. The lease explicitly provided that its terms were binding on any successor or assigns of GAZB. Any purchaser of the interest in the Oxford property from TGP was bound by the terms of the lease.[24]

Petitioners also argue that respondent's appraisals fail to reflect the special features of the Oxford property which were of particular use to Kloppenberg Co. The fact that Kloppenberg Co. may have found certain features of the Oxford building of particular use would not increase the fair market value of the property.[25] Although a buyer might be willing to pay a premium for property which had a special significance or value to that person, that special value would not increase the fair market value. Fair market value is the price which an hypothetical willing buyer will pay an hypothetical willing seller. To acquie the property, it would be necessary only to match the "best" price, i.e., fair market value. Also this record does not support a market value higher than respondent has determined.

Petitioners' advance two additional challenges to respondent's appraisals: that the 9.25-percent discount rate used by Mr. Fernandez in his February 12, 1981, appraisal is too high and that the Trial Appraisal made no allowance for appreciation. While articulating these challenges, petitioners provided no facts in support thereof.

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[24] It is perhaps open to question whether a purchaser of the Oxford property would be able to enforce the increased rent of $1,500 per month or be limited to the rent of $1,000 per month specified in the lease. Neither party has provided controlling authority on this point. However, respondent's appraisals assume an enforceable rent of $1,500 per month. This assumption is favorable to petitioners in that a lower rent would result in a lower fair market value.

[25] George A. Kloppenberg testified in that, in his opinion, the features of the Oxford building did not add to the economic success of Kloppenberg Co. Petitioners themselves do not appear to embrace their counsel's argument as to special use value.

Based on our review of the record we sustain respondent's notices of deficiencies' determinations that the fair market value of the Oxford property interest in issue, on May 3, 1978, was $527,000 and that, of this amount, $254,000 was allocable to the Oxford building.

The Constructive Dividends Issue

Having determined that Kloppenberg Co. paid $473,000 more than the fair market value for the interest in the Oxford property it acquired on May 3, 1978, we must now decide whether that excess constitutes constructive dividends to the Kloppenberg family. For tax purposes, a dividend is any distribution of property made by a corporation to its shareholders out of accumulated or current earnings and profits (after February 28, 1913). Sections 316(a), 301(a)(c); section 1.301-1(j)(1), Income Tax Regs. No formal dividend declaration need be made nor must the distribution be made directly by the corporation. Sparks Nugget, Inc. v. Commissioner, 458 F.2d 631 (9th Cir. 1972), affg. a Memorandum Opinion of this Court. Further, it is well established that a transfer of property between two corporations may constitute a dividend to an individual who has an ownership interest in both corporations. Sammons v. Commissioner, 472 F.2d 449, 451 (5th Cir. 1972); Green v. United States, 460 F.2d 412 (5th Cir. 1972); Commissioner v. Makransky, 321 F.2d 598, 601-602 (3d Cir. 1963), affg. 36 T.C. 446 (1961). In deciding the instant case we are mindful that the "expansive principles governing the treatment of constructive dividends reflect an awareness by Congress and the courts of the ingenious methods which have been devised by owners of closely held corporations trying to escape taxes at the corporate or shareholder level." Baumer v. United States, 580 F.2d 863, 877 (5th Cir. 1978).

Respondent determined that the transfer of the Oxford property to TGP and subsequent sale to Kloppenberg Co. should be severed from the sale of GAZB stock to TGP and the tax consequences of the Oxford property "transaction" analyzed independently.[26] From respondent's perspective, the crucial facts are: (1) that the Kloppenberg family never parted with control over the interest in the Oxford property owned by GAZB; (2) that Kloppenberg Co. purchased GAZB's interest in the Oxford property at a price in excess of its fair market value; and (3) that the shareholders of Kloppenberg Co. received the benefit of this excessive price. Consequently, respondent determined that the excessive purchase price paid by Kloppenberg Co. constituted constructive dividends. Petitioners bear the burden of proving this determination is incorrect. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

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[26] Petitioners mischaracterize respondent's objection to the form of the transaction stating that "[r]espondent urges this Court to reject the form of the transaction only because Petitioners could have simply had GAZB Corporation sell Tejon Property directly to Tejon General Partnership, and such direct route was not taken only because of a desire to avoid the heavy tax bite." In fact, respondent's challenge to the form of the transaction relates solely to the inflated purchase price for the Oxford property and the structure of the transaction to convert what would otherwise be ordinary income to capital gains.

Our resolution of the constructive dividends issue is, in the final analysis, a question of whether the substance of the May 3, 1978, transaction as to the Oxford property comports with its form. As stated in Crenshaw v. United States, 450 F.2d 472, 475-476 (5th Cir. 1971):

> The tax policy of the United States is concerned with realities rather than appearances, and when an illusory facade is constructed solely for the purpose of avoiding a tax burden the astute taxpayer cannot thereafter claim that a court is bound to treat it as being a genuine business arrangement.* * *

See also J. Strickland & Co. v. United States, 352 F.2d 1016 (6th Cir. 1965); Lacy v. Commissioner, 341 F.2d 54 (10th Cir. 1965), affg. 39 T.C. 1100 (1963), affg. Cuckler v. Commissioner, 39 T.C. 1107 (1963), and affg. Trinidad National Bank v. Commissioner, T.C. Memo. 1963-93; Martin v. Commissioner, 44 T.C. 731 (1965), affd. in part 379 F.2d 282 (6th Cir. 1967).

Citing Frank Lyon Co. v. United States, 435 U.S. 561 (1978), petitioners assert that the May 3, 1978, transaction was "a genuine multi-party transaction" with economic substance. As to the Oxford property, this assertion is not supported by the facts. Prior to purchasing the GAZB stock, TGP contracted to sell the Oxford property to Kloppenberg Co. at a price established by GAZB and Kloppenberg Co. On the basis of the evidence of record, we conclude that respondent's characterization of TGP as a "straw man" or conduit is correct. TGP's insertion into the May 3, 1978, transaction created the appearance, but not the substance, of a three-party transaction as to the Oxford property. This Court is not obliged to recognize the structure of a purported transaction, including the ostensible participants, when the form imposed diverges from the substance. Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

In determining the existence of a dividend, the courts have looked to the economic effect of the transactions--the intent of the parties is not dispositive. See Baumer v. United States, supra at 876; Magnon v. Commissioner, 73 T.C. 980, 993-994 (1980); Golsen v. Commissioner, 54 T.C. 742, 754 (1970), affd. 445 F.2d 985 (10th Cir. 1971). In the instant case, the excessive price paid for the Oxford property interest by Kloppenberg Co., after passing through TGP and the Trust without diminution, was paid to members of the Kloppenberg family. The economic substance of this aspect of the challenged transaction was a dividend to said shareholders.

In arguing that the form of the challenged transaction should be observed, petitioner asserts that respondent has failed to show that the underlying documents which comprise the transaction were "shams, illusory, meaningless, or the like." The basic premise of this assertion is incorrect--petitioners have the burden of proving the substance of the transaction comports with its form. Neither respondent nor this Court is required to give credence to underlying documents of a purported transaction merely because such documents have been formally executed. Frank Lyon Co. v.

United States, supra at 573; United States v. Cumberland Public Service Co., 338 U.S. 451 n.3 (1950); Crenshaw v. United States, supra at 475-476; Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1164 (1946), affd. 162 F.2d 513 (10th Cir. 1947). The fact that deeds were executed conveying the Oxford property interest from GAZB to TGP and from TGP to Kloppenberg Co. is not controlling. As stated by the Supreme Court in Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945):

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. [Fn. ref. omitted.]

Petitioners admit that the challenged transaction was structured to "avoid unnecessary tax liability to GAZB and its shareholders." They argue, however, that the transaction had a valid business purpose, i.e., to sell the Tejon property but not the Oxford property to TGP, and that this purpose motivated and permeated the entire transaction. Citing United States v. Cumberland Public Service Co., supra and Bolker v. Commissioner, 81 T.C. 782 (1983), affd. 760 F.2d 1039 (9th Cir. 1985), petitioners further argue that, as a policy matter, it is immaterial that the specific form of the transaction was dictated by tax considerations. What petitioners chose to ignore is the fact that, where transactions serve no "purpose, substance, or utility apart from their anticipated tax consequences," they are disregarded for tax purposes. Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966), affg. 44 T.C. 284 (1965). See also Knetsch v. United States, 364 U.S. 361 (1960); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 185 (1983), affd. in part 732 F.2d 89 (4th Cir. 1985). The only reason for the structure of the challenged transaction was to further the tax objectives of the shareholders of Kloppenberg Co. Requiring TGP to serve as a conduit for the transfer of GAZB's interest in the Oxford property to Kloppenberg Co. does not imbue that transfer with a valid business purpose. Nor can petitioners cite any corporate business purpose served by the excessive purchase price ostensibly paid by Kloppenberg Co. for the Oxford interest. The significant inflation of said price served but one purpose--to attempt to withdraw accumulated earnings from Kloppenberg Co. at capital gains rates.

After careful consideration of each of petitioners' arguments, we conclude that respondent's characterization of the May 3, 1978, transaction as it relates to the Oxford property is correct. In substance, albeit not in form, GAZB sold said interest to Kloppenberg Co. Based on this conclusion, we sustain respondent's determination that the excess purchase price paid by Kloppenberg Co. constitutes constructive dividends to the Kloppenberg family petitioners.

Kloppenberg Co.'s Interest Deduction Issue

In the notice of deficiency to Kloppenberg Co., respondent disallowed the portion of that corporation's interest deduction representing that portion of the payments on the note from Kloppenberg Co. to TGP attributable to the excess purchase price which we have found were constructive dividends.[27] Kloppenberg Co.'s sole argument against this disallowance is that no constructive dividends were paid.[28] Having found to the contrary, we sustain respondent's interest deduction disallowance.

Section 1239 Issue

We now consider respondent's determinations that a portion of the capital gains reported by the individual petitioners should be recharacterized as ordinary income pursuant to section 1239. In pertinent part, section 1239 provides:

> (a) Treatment of Gain as Ordinary Income.--In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.
>
> (b) Related Persons.--For purposes of subsection (a), the term "related persons" means--

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[27] Although we find that George F. Kloppenberg's children did not receive constructive dividends, petitioners failed to advance any argument as to the consequences of this finding on Kloppenberg's interest deduction. As petitioners bear the burden of proving respondent's determination incorrect, we will not attempt to construct arguments or speculate concerning facts it was petitioners' burden to proffer.

[28] Since petitioners have not advanced any argument that execution of the note was the equivalent of a dividend declaration and therefore the interest deductions were proper, we express no opinion as to the merit of such an argument.

> * * *
>
> (2) an individual and a corporation 80 percent or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, or
>
> (3) two or more corporations 80 percent or more in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual.

Respondent's argument that the individual petitioners' ordinary income should be increased pursuant to section 1239 apparently is premised on his position that, prior to May 3, 1978, GAZB was liquidated and its assets distributed. The facts do not support this position. Although a plan of liquidation was adopted by the directors in June 1976, this plan was never voted on or adopted by the shareholders.

We have found that, in substance, GAZB sold its interest in the Oxford property to Kloppenberg Co. Section 1.1239-1(c)(2) provides, in part:

> In general, in the case of a sale or exchange of depreciable property between related corporations (within the meaning of paragraph (b)(3) of this section), gain which is treated as ordinary income by reason of this section shall be taxable to the transferor corporation rather than to a controlling shareholder. However, such gain shall be treated as ordinary income taxable to a controlling shareholder rather than the transferor corporation if the transferor corporation is used by a controlling shareholder as a mere conduit to make a sale to another controlled corporation, or the entity of the corporate transferor is otherwise properly disregarded for tax purposes. * * *

Under this provision, a portion of GAZB's gain on its sale to Kloppenberg Co. would be treated as ordinary income. However, GAZB is not a petitioner in this proceeding. Nor has respondent argued that this corporate entity should be disregarded and its gain imputed to the individual petitioners. In fact, in the context of arguing the impact of the lease between GAZB and Kloppenberg Co. on the fair market value of the Oxford property interest, respondent argues that these corporate entities should not be disregarded. For tax purposes, a corporation is not ordinarily regarded as the alter ego or agent of its shareholders. Deputy v. DuPont, 308 U.S. 488 (1940); Burnet v. Clark, 287 U.S. 410 (1932); Arata v. Commissioner, 277 F.2d 576, 578 (2d Cir. 1960). We see no reason to disregard GAZB's status as a separate and distinct entity. As the individual petitioners did not sell an Oxford property interest, section 1239 is inapplicable to them. Consequently, we hold against respondent on this issue.

Statute of Limitations Issue

The final issue for decision is petitioners' contention that assessment of deficiencies for the earlier year in issue is barred. Section 6501(a) provides the general rule that income tax shall be assessed within 3 years after the return is filed. However, section 6501(c)(4) provides that the period of limitations will not expire if the taxpayer and the Commissioner timely agree in writing to extend the time for assessment. The Commissioner has provided Form 872-A for this purpose.

The parties are in agreement that valid Forms 872-A were executed on behalf of Kloppenberg Co. for its taxable year ending January 31, 1979, and for each of the individual petitioners for the 1978 year.[29] Petitioners argue, however, that the extensions provided by these Forms were effectively revoked by the letter from petitioners' counsel to respondent dated July 21, 1982.

Subsequent to briefing by the parties, this Court has specifically addressed the question of how termination of a Form 872-A extension may be effectively achieved. In Grunwald v. Commissioner, 86 T.C. 85 (1986), the Court determined that:

> The relevant waiver * * * which petitioner signed and which respondent accepted expressly and explicitly sets out the 3 methods by which the period of limitations could be terminated * * *. The very purpose expected to be served by Form 872-T would be frustrated were the parties free to indulge themselves in whatever form of termination might strike their fancy, regardless of the degree of informality chosen. * * *
>
> * * *
>
> * * * A deal is after all a deal, and fairness dictates that both parties adhere to the provisions of the document they both voluntarily signed. * * * [86 T.C. at 89.]

In Grunwald the Court held that a letter sent by respondent's appeal officer did not effectuate a termination of a Form 872-A extension. Similarly, in Jordan v. Commissioner, T.C. Memo. 1986-124, the Court held that a letter from petitioner's counsel to a special agent of respondent "does not conform to the terms of the consent signed by petitioners, [and] it cannot constitute termination of the consents." Based on these controlling precedents, we hold that petitioners' counsel's letter did not effectuate any termination of the Form 872-A extensions. Since the extensions were in effect when the notices of deficiencies were issued, assessment of said deficiencies is not barred by the running of any statute of limitations.

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[29] At trial petitioners raised an argument that the consents executed on behalf of his four children by George F. Kloppenberg were not valid. The Court admonished petitioners' counsel that resolution of this issue would depend on his bringing controlling precedent and applicable law to the Court's attention. As petitioners abandoned this argument on brief, we deem it conceded. In any event, because the children were never shareholders of Kloppenberg Co., we have held for them on the issue of constructive dividends from that corporation.

Decisions will be entered for petitioners in docket Nos. 14931-83, 14932-83, 14933-83, and 14934-83.

Decisions will be entered under Rule 155 in dockets Nos. 14926-83, 14927-83, 14928-83, 14929-83, and 14930-83.

JU 11.7/2:1986-326

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T. C. Memo. 1986-326

UNITED STATES TAX COURT

WILLIAM D. LARIMORE AND FLORENCE LARIMORE, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

ADMIRAL MOVING & STORAGE, INC. (Formerly Beaverton Transfer Co.,
Inc.), Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 29329-82,
29330-82.

Filed July 29, 1986.

Neil J. Driscoll, for the petitioners.

Christine V. Olsen, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

ORIGINAL

Co. M.

Docket No.	Petitioner	Year	Deficiency
29329-82	William D. Larimore & Florence Larimore	1978	$1,473.00
		1979	2,361.00
29330-82	Admiral Moving & Storage, Inc. (Formerly Beaverton Transfer Co., Inc.)	1975	312.00
		1978	1,808.50
		1979	997.00

The issues for decision are as follows:

(1) The extent to which the corporate petitioner is entitled to business expense deductions under section 162,[1] depreciation deductions under section 167, and investment credit under section 38, for the costs and expenses it incurred during 1978 and 1979 in the acquisition, operation, and maintenance of two Mercedes Benz automobiles;[2] and

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

[2] The corporate petitioner's deficiency for 1975 results from respondent's disallowance of a carryback of petitioner's unused new jobs credit for 1978 in such amount. Respondent disallowed the carryback because his reduction of petitioner's 1978 investment credit eliminated the new jobs credit carryback.

(2) Whether the individual petitioners received compensation[3] and/or constructive dividend income relating to the automobiles.

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[3] The statutory notice of deficiency treated as constructive dividends to the individual petitioners the rental value of both automobiles and certain expenses paid by the corporation. At the commencement of the trial, the Court raised the possibility that some amounts could be compensation to the individual petitioners and thus deductible by the corporate petitioner. At the conclusion of the trial, respondent's counsel moved to amend the pleadings to conform to the proof to allege that if the payments in regard to the Mercedes were not constructive dividends to Mrs. Larimore that they were income to her. The Court responded as follows:

> Well, the Court had asked the question about that at the outset because it appeared to me that both sides seemed to be overlooking what seemed to the Court to be an alternative position that would give the corporation its deduction but have the amount includable in the individual's income, and particularly since it is now clearly established for the record that Mrs. Larimore did in fact work for the corporation, which had not been clear at the outset.
>
> There's certainly no question about reasonable compensation since she got zero. Anything above that would clearly be reasonable, so I would just suggest instead of formally amending the pleadings that both sides should address the issue in their briefs.

Respondent did address the issue on brief; petitioners alluded to the issue but did not really discuss it.

Since the factual record has been fully developed by the parties and since the compensation vs. dividend issue was raised at the outset of the trial, albeit by the Court itself, the Court considers this issue properly before the Court despite the lack of formally amended pleadings. The Court itself, in its effort to simplify matters and to foster an environment for settlement of the case after trial (n.14, infra), is responsible for the fact that the pleadings were not formally amended. Accordingly, the Court will treat the case as if the answer had been amended

(footnote continued)

FINDINGS OF FACT[4]

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

William D. Larimore (Mr. Larimore) and Florence Larimore (Mrs. Larimore) (collectively, the Larimores or the individual petitioners), husband and wife, resided in West Linn, Oregon, at the time they filed their petition in this case. Admiral Moving & Storage, Inc. (formerly Beaverton Transfer Co., Inc.) (the corporation) had its principal place of business or principal office or agency in West Linn, Oregon, at the time it filed its petition in this case. The individual petitioners filed their

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(footnote continued from previous page)
and petitioners had denied the allegations. The compensation issue being "new matter," respondent will of course bear the burden of proof. Rule 142(a). If the Court finds any increased compensation to the individuals, it will allow a corresponding deduction to the corporation.

[4] At the trial of this case, George W. Tombe testified that during 1978 and 1979, he was employed by the corporate petitioner. He testified at length about various aspects of the corporation's operations in those years, particularly in regard to use of the two Mercedes automobiles. Three months after the trial, respondent filed a motion to reopen the record for the purpose of admitting into evidence Mr. Tombe's tax returns and his affidavit so that the Court could strike his testimony as irrelevant, incompetent, and inadmissible. The tax returns and Mr. Tombe's affidavit establish that Mr. Tombe was not employed by the corporate petitioner during 1978 or 1979. After receiving petitioners' objection to respondent's motion, the Court denied respondent's motion to reopen the record to strike Mr. Tombe's testimony. However, the Court has not relied upon his testimony in making its findings of fact. To a large extent, Mr. Tombe's testimony duplicated that of the individual petitioners.

1978 and 1979 joint U.S. income tax returns (Forms 1040) with the Internal Revenue Service Center in Ogden, Utah. The corporation filed its 1978 and 1979 U.S. corporation income tax returns (Forms 1120) with the Internal Revenue Service Center in Ogden, Utah.

During 1978 and 1979, the corporation was engaged in the moving and storage business. During such years, Mr. Larimore was the corporation's president and sole stockholder. Mr. Larimore has been in the moving business since 1960. As president, Mr. Larimore oversaw the corporation's entire business. In particular, Mr. Larimore was heavily involved in the sales end of the business, especially large corporate accounts. The corporation paid Mr. Larimore wages totaling $28,600 during 1978, and $37,400 during 1979.

During 1978 and 1979, Mrs. Larimore was the corporate secretary. Before those years, Mrs. Larimore had suffered a brain aneurysm, but she had fully recovered and was back at work by January 1, 1978. She worked full-time for the corporation during the years in issue. She worked the same hours that Mr. Larimore did; they considered themselves partners in the business. The Larimores worked an average of 10 hours each day, usually 6 days a week. As the corporation's secretary, Mrs. Larimore performed the duties of an office manager and a corporate comptroller. She did general bookkeeping, made up the payroll, did the corporation's banking, consulted with the corporation's certified public accountant, William F. Holdner, (the CPA), purchased office supplies, handled the corporation's mail, and generally did anything else in the office that needed to be done. During the years in issue, the corporation did not pay Mrs. Larimore any salary or wages.[5]

During the years in issue, the corporation never declared or paid any dividends. During such years, the corporation employed between 22 and 40 people, depending on its workload. Four of those employees, in addition to Mr. Larimore, were on the sales staff.

At the beginning of 1978, the corporation owned a number of passenger automobiles, including a 1973 Mercedes Benz, a 1975 Datsun 280Z, a Volkswagen, a Volkswagen Dasher, two Chevrolet Vegas (one a 1971, and the other a 1972 or 1973 model), and a Buick Riviera. The corporation sold the 1973 Mercedes Benz in April of 1978 and sold the Datsun 280Z in May of 1978. Of the remaining automobiles, only three, the two Volkswagens and the later model Vega, were reasonably reliable. However, all of the automobiles were covered under the corporation's insurance policy. The earlier model Vega had some engine problems, and also needed new brakes and tires. The Buick was expensive to operate, and therefore Mr. Larimore was reluctant to use it. He quit driving the Buick, and the longer it sat without being used, the more difficult it became to start and the more problems it developed. The corporation's business required that it have some reliable automobiles. The three automobiles that were in reasonably good operating condition were used by the sales staff and were "marked," that is, they had billboards on each side with the corporation's name on them. The record does not establish that there were any operating problems with either the 1973 Mercedes or the Datsun 280Z that were sold in 1978.[6]

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[5] Mr. Larimore testified that she was paid no salary because the corporation was a struggling young company, and because of the competitive nature of its market area, its earnings were plowed back into the business. He further testified that the corporation simply did not have the money to pay her a salary. The Court does not accept this testimony. The business was incorporated in 1972, and reported taxable income of $38,874 and $24,730 in 1978 and 1979, respectively. Also the corporation purchased the two Mercedes automobiles in 1978.

On January 10, 1978, the corporation purchased a new 1978 Mercedes Benz 240-D diesel engine automobile (the 240-D) for $14,364. The title to the 240-D was registered in the corporation's name upon its purchase. The minutes of the annual stockholders meeting held on January 2, 1978, stated that "[a]s a bonus for her [Mrs. Larimore's] efforts thru the years Mr. Larimore said he would look for a new auto for her." On April 24, 1978, the corporation purchased a used 1975 Mercedes Benz 450-SL gasoline engine automobile (the 450-SL) for $17,004. The 240-D and the 450-SL are sometimes collectively referred to herein as the Mercedes automobiles. Although the 450-SL was purchased with the corporation's funds, the title to the automobile was registered in the names of Mr. and Mrs. Larimore.[7] Mr. Larimore selected the 450-SL without Mrs. Larimore's help. During the years in issue, the individual petitioners had no other automobile registered in their names except the 450-SL.

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[6] The corporation was required to recapture part of the investment credit claimed earlier for these cars because they were disposed of before the expiration of their useful lives. While the Court was favored with detailed testimony about the poor condition of the cars the corporation retained, the record is conspicuously silent as to the condition of the 1973 Mercedes and the Datsun 280Z that were sold in 1978.

Mr. Larimore put most of the miles on the 240-D. He used it for a variety of business purposes, including calling on corporate accounts, that is, large corporations that contracted to move the belongings of their personnel. He also used the 240-D for other business purposes, including surveying households so that he could estimate the cost of moving them, collecting accounts receivable, performing post-move surveys of customers to evaluate the corporation's performance (these were required by the corporation's major van lines affiliate at the time, Global Van Lines), attending sales and other seminars given by Global

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[7] Mr. Larimore testified that the 450-SL was titled in his wife's name temporarily. That is not correct. He further testified it was titled in her name because the corporation was in the process of changing the major van lines with which it was affiliated, which would require a change in the corporation's name, and the corporation did not want to register the title to the 450-SL in its name and then have to change the registration after its corporate name change. The Court did not believe this explanation. The same argument could be made as to the 240-D but that vehicle was titled in the name of Beaverton Transfer Co., Inc., the old corporate name. In any event, the corporation changed its name on September 29, 1980, but the title to the 450-SL (in the names of both Mr. and Mrs. Larimore) was not changed until after the Internal Revenue Service asked to see the title during the audit.

Van Lines that Mr. Larimore was required to attend, and running general business errands. Other employees of the corporation also used the 240-D on occasion for various business purposes.

Petitioners considered the 450-SL to be "Flo's [Mrs. Larimore's] car." She used the 450-SL for a variety of business and personal purposes. She drove it to the bank to make daily deposits, to the CPA's office roughly twice a week, to buy office supplies about twice a week, and to make a daily trip to the post office. She also ran personal errands while on business errands. Other employees of the corporation also used the 450-SL for various business purposes. Members of the sales staff drove it when they wanted an "unmarked car." Other office employees used it to pick up office supplies. The corporation's mechanic used it to get parts. Other employees drove the 450-SL to job sites to take extra packing material or to supervise the job. They also used it when making claim estimates, that is, to go to a customer's house or office to check any claimed damage incurred during a move. However, none of the corporation's employees other than the Larimores ever drove the 240-D or the 450-SL to their homes at night.

In addition to the business uses of the Mercedes automobiles described above, the Larimores also used both automobiles for personal purposes. They used at least one of the Mercedes automobiles to commute between their home in West Linn, a suburb of Portland, Oregon, to the corporation's office in Tigard, Oregon, another Portland suburb, about a 20-mile roundtrip. This amounted to about 6,000 miles per year for commuting. The Larimores frequently drove to and from work together in the 240-D, and left the 450-SL at the corporation's office at night. Sometimes both cars were driven home and used for commuting. The Larimores always drove separately when Mr. Larimore had a business appointment after hours or when he went out of town for a seminar. If the corporation had a move in the general vicinity on his way home, Mr. Larimore sometimes stopped by to see how things were going, or to say hello to the customer. Mr. Larimore also sometimes conducted the post-move surveys on his way home in the evening.

During the years in issue, the Larimores spent their recreational time on a power boat they kept moored on the Columbia River, about 14 miles from the corporation's office. They spent many weekends on the boat, usually driving there in the 240-D straight from the corporation's office. Occasionally, the Larimores would make a business stop on the way to or from the boat.

Mr. Larimore also needed an automobile when he was at home or at the boat so that he could take care of any business problems that might arise during nonbusiness hours. The Larimores' other personal uses of the Mercedes automobiles frequently took place on the way to work in the morning, during the middle of the day, or on the way home from work in the evening.

Despite the mixed business and personal uses of both Mercedes automobiles, the corporation paid all operating and maintenance expenses for them. The corporation paid insurance premiums during 1978 and 1979 in the amounts of $350 for the 240-D, and $400 for the 450-SL each year. The corporation also paid for all fuel used to operate both Mercedes automobiles during the years in issue. During those years, the retail price of diesel fuel for the 240-D was about $.75 per gallon, and the retail price of gasoline for the 450-SL was about $.95 per gallon. However, the corporation never bought fuel for the automobiles at retail. The corporation purchased both diesel fuel and gasoline at wholesale and stored it in big storage tanks it owned, one for diesel fuel and one for gasoline. The corporation used such fuel to operate its moving vans, sales automobiles, and the two Mercedes automobiles. The wholesale price the corporation paid for diesel fuel was about $.40 per gallon during 1978, and about $.55 per gallon during 1979. The wholesale price the corporation paid for gasoline was about $.60 per gallon during 1978, and about $.75 per gallon during 1979. The 240-D averaged 30 miles per gallon and the 450-SL averaged 14 miles per gallon.

The corporation also paid all maintenance expenses for both Mercedes automobiles. However, during the years in issue, both automobiles were under warranty and both ran basically trouble-free, so the corporation's out-of-pocket expenses were minimal.

The 240-D was under warranty from the time of purchase until the longer of two years or 50,000 miles. The warranty covered almost everything except tires. The corporation's primary maintenance expenses were for oil and oil filter changes. Mr. Larimore or the corporation's mechanic did the work.[8] During 1978 and 1979, the corporation incurred expenses for oil and oil filters for the 240-D in the amounts of $31.95 and $33.50, respectively. During those years, the average routine maintenance expenses for a 1978 240-D through the first 19,000 miles were between $300 and $350. For the next 17,000 miles, average routine maintenance expenses were a little higher.

The 450-SL was also under warranty up to 50,000 miles. However, the 450-SL had 15,000 miles on it when the corporation bought it so that only 35,000 miles of warranty coverage remained. The warranty was not complete, but covered most items. The only maintenance expenses that the corporation incurred for the 450-SL during 1978 and 1979 were for oil and oil filter changes, valve adjustments, and tune-ups. Again, Mr. Larimore or the corporation's mechanic performed the maintenance work. See n.8, supra. The corporation incurred out-of-pocket maintenance expenses for the 450-SL in the amounts of $88.54 during 1978, and $33.72 during 1979. During those years, average routine maintenance expenses for a 1975 Mercedes Benz 450-SL for mileage between 15,000 miles and 25,000 miles were between $400 and $600.

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[8] Neither party considered the value of their company time and labor as either an expense to the corporation or an additional dividend to Mr. and Mrs. Larimore. The Court will disregard the item as de minimis.

Neither the corporation nor the individual petitioners kept any records of business or personal use of either Mercedes automobile. The individual petitioners reimbursed the corporation a total of $600 ($25 per month per automobile) each year for their personal use of the Mercedes automobiles. During 1978 and 1979, the fair rental value of a new 1978 240-D was between $280 and $290 per month. During those years, the monthly lease charge for a used 1975 450-SL was about $350. These monthly lease figures did not include operating and maintenance expense; i.e., the lessee was responsible for operating and maintenance expenses. However, those fair rental figures would include some profit for the lessor.

On its 1978 return, the corporation claimed investment credits for the Mercedes automobiles in the amount of $2,089, computed as follows:[9]

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[9] The parties stipulated to these figures. The calculations are not accurate. $14,364 x .6667 = $9,576.48. $17,004 x .6667 = $11,336.57. $9,576.48 + $11,336.57 = $20,913.05. $20,913.05 x 10 percent = $2,091.31.

Automobile	Cost	Useful Life	Applicable Percentage	Qualified Investment
240-D	$14,364	5-6 yrs.	66.67%	$ 9,566
450-SL	17,004	5-6 yrs.	66.67%	11,325
Total qualified investment:				$20,891
Regular percentage				10%
Investment credit				$ 2,089

The investment credits claimed by the corporation were based on 100-percent business use of the two automobiles.

On its 1978 and 1979 returns, the corporation claimed depreciation deductions for the Mercedes automobiles as follows:[10]

Claimed Deduction	1978	1979
240-D depreciation	$2,000	$2,000
450-SL depreciation	2,000	3,000

The depreciation deductions claimed by the corporation for the Mercedes automobiles were based on 100-percent business use of such automobiles. The corporation also deducted 100 percent of all insurance, operating expenses, and maintenance expenses in regard to the two Mercedes automobiles; these expenditures cannot be identified on the tax returns but are included in the lump sum figures for "other deductions" of $220,774 and $288,928, for 1978 and 1979, respectively.

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[10] The parties stipulated to these figures without any explanation as to the basis for computation. The 1978 and 1979 corporate returns showed total of depreciation of $17,908 and $16,519, respectively, for "transportation equipment," which we assume includes the automobiles as well as the moving vans.

On their 1978 and 1979 returns, the Larimores did not report any income from their personal use of the Mercedes automobiles. Mr. Holdner, the corporation's CPA, prepared the returns for both the corporation and the Larimores in 1978 and 1979.

In late 1980 or early 1981, respondent's revenue agent, Rita M. McCutcheon (the revenue agent), began auditing the corporation's 1978 and 1979 returns. Mr. Holdner bore primary responsibility for handling the audit for the corporation. The revenue agent reviewed the corporation's books and records at the CPA's office. On March 27, 1981, the revenue agent requested the titles to the Mercedes automobiles. On April 24, 1981, the title to the 450-SL was transferred from the Larimores to the corporation.

On April 20, 1981, the revenue agent received from the corporation's CPA a handwritten document that Mr. Larimore had prepared, titled "Admiral Moving and Storage--Flo's Car Breakdown of Mileage by Month." That handwritten document listed the following uses and mileage each month for the 450-SL:

Use	Mileage
Bank deposits	45
Accounting	158
Pick up and deliver help to jobs	105
Supplies	95
To discuss billing problems	140
Deliver estimates (local)	95
Make estimates (local)	60
Long distance trips for estimates	135
Deliver claim forms & discuss claims	95
Other personnel using car	110
	1,038
Back and forth to work	440
Total	1,478

The revenue agent asked for and obtained during the audit various corporate repair invoices and records for the Mercedes automobiles. By comparing mileage figures on these documents, she estimated total mileage for the Mercedes automobiles to be just under 19,000 miles each year for the 240-D and about 10,000 in 1978 and about 15,000 in 1979 for the 450-SL.

Sometime during December of 1981, while she was still auditing the corporation and the individual petitioners, the revenue agent met with Mr. Larimore and the CPA. At that meeting, Mr. Larimore stated that the 240-D was used 60 percent for business purposes and the 450-SL was used between 10 and 20 percent for business purposes.[11] After the meeting, the revenue agent sent Mr. Larimore a letter dated January 13, 1982, which stated, inter alia, as follows:

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[11] However, at the trial, Mr. Larimore stated he could not remember whether he made this statement. The CPA testified that these percentages were discussed at the meeting but were suggested by the revenue agent. The CPA further testified he did not agree with such figures. The Court found the revenue agent's testimony more credible than that of Mr. Larimore or the CPA.

> Based on the lack of record keeping indicating the actual business use of the two Mercedes your oral statement made December 23, 1981 has been accepted. This will allow 60% of the 1978 240D Mercedes expenses to be deductible per Section 162 by your corporation. The 40% disallowed together with the fair market value of the vehicle will be considered a constructive dividend to you.
>
> Expenses relating to the 1975 450 SL have been allowable [sic] to the corporation to the extend [sic] of 20%. The 80% disallowed expenses will be considered a dividend together with the Fair Market Value of the vehicle to the extent of 80%.

In February of 1982, the corporation sold its moving and storage business. At that time, the corporation still held title to both Mercedes automobiles. By then, the 240-D and the 450-SL had each been driven about 100,000 miles. At that time Mr. Larimore estimated that over the roughly four-year period from the time the corporation acquired the automobiles in early 1978 until the corporation sold its business, the mileage had been put on both automobiles fairly uniformly. Based on this assumption, Mr. Larimore in 1982 prepared a series of four handwritten summaries, one for each of the Mercedes automobiles for each year in issue, estimating the personal use percentages and related expenses for the automobiles. These handwritten summaries were later typed up with a few minor changes and submitted into evidence to explain petitioners' computation of the personal use percentages and the expenses related thereto.[12] Except for the items of insurance and depreciation as to which the parties stipulated, and the items of oil, filters, and maintenance, as to which Mr. Larimore apparently located some corporate invoices and records, there is no evidence to support the other figures and estimates in his summaries. Those summaries are unsupported

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[12] The figures set forth on petitioners' typewritten summaries are as follows:

	240-D		450-SL	
Item	1978	1979	1978	1979
Total miles	25,091	24,972	20,360	21,275
Personal miles	2,526	2,788	1,785	1,932
Business miles	22,565	22,184	18,575	19,343
Personal use percentage[1]	10.00%	11.20%	8.77%	9.08%
Fuel[2]	$ 333.33	$ 458.33	$ 872.56	$1,139.73
Oil, filters, and maintenance	31.95	33.50	88.54	33.72
Insurance	350.00	350.00	400.00	400.00
Depreciation	2,000.00	2,000.00	2,000.00	3,000.00
Total expenses	$2,715.28	$2,841.80	$3,361.10	$4,573.45
Personal use percentage of total expenses[3]	$ 271.52	$ 318.28	$ 294.76	$ 415.26

[1] Personal miles divided by total miles.

[2] For the 240-D, total miles divided by 30 miles per gallon, times $.40 per gallon of diesel fuel for 1978, and $.55 per gallon for 1979. For the 450-SL, total miles divided by 14 miles per gallon, times $.60 per gallon of gasoline for 1978, and $.75 per gallon for 1979.

[3] Total expenses times personal use percentage.

There are numerous computational and rounding errors in the above figures, too many to itemize. Despite the seeming precision of these summaries, there is little or no evidence in the record to support these figures. Accordingly, except as expressly noted in the text, we accord them no weight.

statements of his position; they lack any evidentiary basis, particularly the total mileage and personal mileage estimates. The depreciation figures, as noted earlier, represent the 100-percent depreciation deductions the corporation claimed on its 1978 and 1979 returns.

In the statutory notice of deficiency to the corporation dated October 29, 1982, respondent reduced the corporation's depreciation deductions for 1978 and 1979 by the amounts of $2,400 for 1978 and $3,200 for 1979, determined as follows:

	1978		1979	
	240-D	450-SL	240-D	450-SL
Depreciation claimed by the corporation	$2,000	$2,000	$2,000	$3,000
Personal use of auto determined by respondent	40%	80%	40%	80%
Disallowed depreciation per auto	$ 800	$1,600	$ 800	$2,400
Total disallowed depreciation for year	$2,400		$3,200	

Respondent disallowed other deductions claimed by the corporation for the Mercedes automobiles in the amounts of $1,367 for 1978, and $1,823 for 1979.[13] Respondent also disallowed 40 percent of the investment credit claimed by the corporation on its 1978

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[13] The breakdown of these figures is not part of the evidentiary record. Respondent attached the breakdown to his trial memorandum, used the document to refresh the revenue agent's recollection at trial, but never offered it. Since this breakdown, like Mr. Larimore's summaries (n.12, supra), is just a statement of position, the Court includes it merely to show respondent's computations:

450-SL	1978	1979
Mileage	10,419	15,624
MPG	14	14
Gallons used	744	1,116
Price per gallon	$.95	$.95
Fuel expense	$707	$1,060
Maintenance expense	567	850
Total expense	$1,274	$1,910
Less 20% business use	(255)	(382)
Total	$1,019	$1,528
240-D		
Mileage	18,768	18,768
MPG	30	30
Gallons used	626	626
Price per gallon	$.75	$.75
Fuel expense	$470	$470
Maintenance expense	400	400
Total expense	$870	$870
Less 60% business use	(522)	(522)
Total	$348	$348
450-SL fuel & maintenance	$1,019	$1,528
240-D fuel & maintenance	348	348
240-D insurance	344	322
450-SL insurance	263	225
Less reimbursement	(600)	(600)
Total disallowed	$1,374*	$1,823

*This figure is erroneously shown in the statutory notice of deficiency as $1,367.

return for the 240-D, and 80 percent of the credit claimed for the 450-SL.

In the statutory notice of deficiency dated October 29, 1982, to the individual petitioners, respondent increased their gross income for constructive dividends received from the corporation during 1978 and 1979 as follows:

	1978	1979
240-D fair rental value	$1,488	$1,488
450-SL fair rental value	2,336	3,504
Automobile expenses paid by the corporation	1,367	1,823
Total constructive dividends	$5,191	$6,815

OPINION

In this case, a wholly-owned corporation purchased two Mercedes automobiles that the sole stockholder and his wife regularly used for both business and personal purposes. One of the vehicles was titled in the corporation's name and one in the individuals' names. Neither the corporation nor the individuals maintained any records as to the business or personal use of these automobiles. The corporation paid and deducted on its tax returns all expenses of operating and maintaining both vehicles. The corporation also claimed depreciation deductions and investment credits based on 100-percent business use of both vehicles. On their tax returns, the individuals did not report any amount as compensation and/or constructive dividend income from the corporation's purchase or their personal use of the Mercedes automobiles. They did pay the corporation $600 each year for their personal use. However difficult it may be to maintain contemporaneous records of business or personal use and expenses for automobiles, litigating such issues is not without its pains.[14]

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[14] Even at the conclusion of the trial, the Court urged the parties to try to settle this case, expressing the view that the case could have been settled had petitioners' counsel been in the case from the beginning. Petitioners did not retain counsel until the first day of the two-day trial. Despite that handicap, petitioners' counsel tried the case in a thoroughly competent, professional manner. Regrettably the parties could not or would not settle after trial. The post-trial environment for settlement, which the Court tried to foster, may have been poisoned by an unfortunate incident of tainted evidence. After

(footnote continued)

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The Corporation's Deductions and Credits

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for compensation paid for personal services actually rendered. The expenses of operating automobiles used in the trade or business are also deductible under section 162. Sec. 1.162-1(a), Income Tax Regs. However, section 262 precludes a deduction for personal, living, or family expenses. Expenses incurred by a taxpayer in traveling between his residence and his regular place of employment are personal commuting expenses and therefore nondeductible. Secs. 1.162-2(e), 1.262-1(b)(5), Income Tax Regs.; Commissioner v. Flowers, 326 U.S. 465 (1946); Hynes v. Commissioner, 74 T.C. 1266, 1295-1296 (1980).

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business. The taxpayer must own the property or make and maintain a capital investment in

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(footnote continued from previous page)
trial, respondent discovered that one of petitioners' witnesses who testified he worked for the corporation during 1978 and 1979, and who testified at length about the business use of the vehicles in those years, did not in fact work for the company at that time. While the Court did not grant respondent's motion to reopen the record to strike Mr. Tombe's testimony, the Court has not relied upon it in its findings of fact. See n.4, supra. However, the Court is satisfied that petitioners' counsel, as he advised the Court, had no knowledge at the time of the trial of the Tombe matter.

property to be entitled to a depreciation deduction with respect to such property. See Miller v. Commissioner, 68 T.C. 767, 775 (1977). At all times pertinent to this case, section 38 allowed a credit against Federal income taxes for qualified investment in "section 38 property," as defined in section 48(a)(1). Section 38 property includes tangible personal property with respect to which depreciation is allowable, i.e., property used in a trade or business. Sec. 167(a)(1). If a depreciation deduction is allowable with respect to only a part of the property, then only that part of the property qualifies as section 38 property. Sec. 1.48-1(b)(2), Income Tax Regs.

It is well established that where corporate property is used by a shareholder or a member of his family for purposes not proximately related to the corporate business, the corporation is not entitled to deductions to the extent of such personal use. Falsetti v. Commissioner, 85 T.C. 332, 356 (1985).[15] It is incumbent upon taxpayers to keep records sufficient to enable the Commissioner to correctly determine their income tax liability. Sec. 6001. See sec. 1.162-17(d)(2), Income Tax Regs. Here, both the corporation and the individual petitioners failed to keep any records whatsoever pertaining to the business or personal use of the Mercedes automobiles. However, where the Court is convinced that legitimate business expenses were actually incurred by the taxpayers, we may, under appropriate circumstances, approximate the amount of expense deductions the taxpayers are entitled to. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Where, as here, corporate property is used for both business and personal use, an allocation between uses must be made. Henry Schwartz Corp. v. Commissioner, 60 T.C. 728, 744 (1973). With these principles in mind, we turn now to the facts of this case.

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[15] See also Whipple Chrysler-Plymouth v. Commissioner, T.C. Memo. 1972-55, and cases cited therein.

The corporation claimed depreciation deductions and investment credit for the two Mercedes automobiles based on 100-percent business use, and the corporation deducted all expenses of operating and maintaining both vehicles. Respondent disallowed 40 percent of such deductions and investment credit for the 240-D, and 80 percent thereof for the 450-SL, determining that such percentages represented the Larimores' personal use of the automobiles. At trial the issue was raised as to whether some amounts might be additional compensation to the Larimores rather than constructive dividends, hence deductible by the corporation. See n.3, *supra*.

The 450-SL as Compensation

About three months before the corporation purchased the 450-SL, at an annual stockholders meeting, Mr. Larimore said that he would look for a new auto for Mrs. Larimore "[a]s a bonus for her efforts through the years." During the years in issue, Mrs. Larimore rendered substantial services to the corporation, worked the same long hours that Mr. Larimore did, but received no wages or salary. The 450-SL was purchased with corporate funds, but title to the automobile was registered in the Larimores' names. The Larimores as well as other company employees referred to the 450-SL as "Flo's [Mrs. Larimore's] car." During the years in issue, the Larimores owned no other automobile. Title to the 450-SL remained in the Larimores' names until April 24, 1981, when the Larimores transferred title to the corporation following the revenue agent's request to see the titles to the two Mercedes automobiles. These facts convince us that the 450-SL was purchased by the corporation, and the title thereto was registered in the Larimores' names as payment of compensation for the valuable services Mrs. Larimore rendered to the corporation. The amount of such compensation was reasonable and was equal to the purchase price of the 450-SL, $17,004.

Accordingly, the corporation is entitled to a deduction under section 162(a)(1) for compensation paid in the amount of $17,004 for 1978. Consequently, the corporation is not entitled to any depreciation deductions or investment credit for the 450-SL. However, since the 450-SL was used for business purposes, the Larimores are entitled to an investment credit and depreciation deductions for the business use percentage.

Business and Personal Use of Both Automobiles

No contemporaneous records of business or personal use having been maintained by either the corporation or the Larimores, we are left with a series of estimates, none wholly satisfactory and some woefully inadequate. This lamentable state of the record prevails even as to total mileage figures per year, something petitioners could have easily documented at the time by simple odometer readings each year.

Respondent determined the total annual mileage for the Mercedes automobiles by comparing the mileage shown on various corporate invoices and repair records. See n.13, supra. These figures have the merit of coming from actual corporate records, but there were so few repairs and actual out-of-pocket expenditures by the corporation that the documentation was sparse and sporadic.

There is also in the record a handwritten document listing the uses made of the 450-SL during the years in issue and the monthly mileage involved in such uses. Mr. Larimore prepared this handwritten document during the audit (Larimore I). While we might normally reject this as a purely self-serving document, worthy of little weight, the document on its face reflects considerable thought and care in its preparation. Intrinsically, the document reflects completeness in the types and numbers of business trips and distances traveled for each such purpose. The various types of business trips were borne out by the sworn testimony of Mr. and Mrs. Larimore. Since this document was prepared by Mr. Larimore based upon his personal knowlege and offered by respondent, the Court received it in evidence and is inclined to accord it weight as to both business uses and mileage for the 450-SL. According to this document, the 450-SL was driven 1,478 miles each month,[16] or 11,824 miles during 1978 and 17,736 miles during 1979.

At trial, however, Mr. Larimore attempted to repudiate his document. He testified that Larimore I was prepared while he was very busy with other corporate matters and prepared without much thought. The document itself, while handwritten, indicates otherwise. What petitioners offered at trial, a neatly typed series of detailed computations (Larimore II), has no evidentiary foundation whatsoever. See n.12, supra. Petitioners do not explain how Mr. Larimore arrived at the figures on this document.[17]

Thus, for total mileage, the Court has three estimates of dubious worth:

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[16] The corporation acquired the 450-SL on April 24, 1978, so it was used approximately eight months during 1978. 8 x 1,478 = 11,824. For 1979, 12 x 1,478 = 17,736.

[17] The only evidence petitioners submitted to support Larimore II was Mr. Larimore's testimony that by the time the corporation sold its business in February of 1982, both automobiles had been driven about 100,000 miles, that 100,000 miles divided by four years yields a mileage estimate for the 240-D of roughly 25,000 miles per year, and that 100,000 miles less the 15,000 miles that were already on the 450-SL when purchased, or 85,000 miles, divided by four years yields an estimated annual mileage figure for it of 21,250 miles. That does not begin to explain the precise figures in Larimore II, and the document is not otherwise self-authenticating.

	450-SL		240-D	
	1978	1979	1978	1979
Revenue agent	10,419	15,624	18,768	18,768
Larimore I	11,824	17,736	--	--
Larimore II	20,360	21,275	25,091	24,972

We conclude that Larimore I, itemizing the miles for the various uses of the 450-SL, is the most reliable estimate for that purpose. Thus, we find as a fact that the 450-SL was driven 11,824 miles during 1978 and 17,736 during 1979. Petitioners provided no evidentiary basis for their estimates of the 240-D's annual mileage. Petitioners having failed to carry their burden of proof, we sustain respondent's determination and find as a fact that the 240-D was driven 18,768 miles each year.[18] Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Having determined total annual mileage for both Mercedes automobiles, we next consider what portions thereof were for business and personal purposes. Respondent determined that the 240-D was used 60 percent for business and 40 percent for personal purposes, and the 450-SL 20 percent for business and 80 percent for personal purposes. Those percentages were based on statements by Mr. Larimore during the audit that the revenue agent simply accepted.

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[18] The revenue agent testified that from the corporate invoice and repair records she determined total mileage of just under 19,000 for each year. Her computations were used to refresh her recollection but not offered in evidence. See n.13, supra. The computation is just a statement of respondent's position, but we will use the exact figure of 18,768 since this was used for the notice of deficiency.

Petitioners now contend that the percentage of personal use for the 450-SL was 8.77 percent during 1973 and 9.08 percent during 1979. Similarly, they now claim that the personal use percentage for the 240-D was 10 percent and 11.20 percent, respectively, for each year. Aside from the fact that these figures from Larimore II are wholly lacking in any evidentiary support (see n.12, supra), these figures are completely unrealistic and demonstrably too low. The Larimore II computations show total personal mileage of only 4,311 miles in 1978 and only 4,720 miles in 1979. The Larimores, however, drove 6,000 miles each year just going to and from work. These commuting miles are strictly personal and nondeductible.[19]

Mr. Larimore's earlier itemized listing of monthly mileage for the 450-SL (Larimore I) indicates 440 of the 1,478 miles as personal use per month. These figures yield a business use percentage of 70 percent and personal use of 30 percent. We so find, relying upon Larimore I for the reasons indicated earlier. The finding is borne out to some extent by the oral testimony as to the many business uses of the 450-SL.[20] As to the 240-D we rely upon Mr. Larimore's earlier estimate of 60 percent business and 40 percent personal use, treating that estimate as either an admission by petitioners or a failure to sustain their burden of proof. Welch v. Helvering, supra.

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[19] The corporation improperly treated all of the Larimores' commuting mileage as business use. The testimony of both the Larimores and the CPA conveyed a disturbing impression that they thought driving to and from work somehow becomes a deductible business expense if any business errand is performed along the way. That is not correct. The Larimores have totally failed to show that they would not have driven the same mileage for commuting and incurred the same expenses without regard to any business stops enroute. See Fausner v. Commissioner, 413 U.S. 838 (1973); Feistman v. Commissioner, 63 T.C. 129 (1974).

Operating and Maintenance Expenses

As detailed in the findings of fact (see n.13, supra), respondent used the retail price of diesel fuel and gasoline to calculate these expenses. Petitioners argue we should not use the retail price but the wholesale price, since the corporation purchased diesel fuel and gasoline only at wholesale. We agree. Use of average wholesale prices more accurately approximates the corporation's actual expenses. The corporation's average cost for diesel fuel was about $.40 per gallon during 1978, and about $.55 per gallon during 1979.[21] The average wholesale price the

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[20] While the Court cannot understand why an automobile that gets only 14 miles to the gallon would be used so extensively for business purposes, the Court is persuaded that it was. Respondent has not raised any issue as to whether the expenditures were excessive and hence not ordinary and necessary.

[21] The parties stipulated that the wholesale price for diesel fuel both years was about $.40 per gallon. However, after reviewing the corporation's records, Mr. Larimore testified that the corporation's average cost for diesel fuel was about $.40 per gallon during 1978 and about $.55 per gallon during 1979. The Court will not lightly disregard a fact agreed to by the parties in the stipulation. Jasionowski v. Commissioner, 66 T.C. 312, 318 (1976). However, in unusual circumstances, when a stipulated fact is clearly contrary to the record presented to us at trial, the Court will not be bound by the stipulation. Mead's Bakery, Inc. v. Commissioner, 364 F.2d 101 (5th Cir. 1966), affg. on this

(footnote continued)

corporation paid for gasoline was about $.60 per gallon during 1978, and about $.75 per gallon during 1979. Thus, we find the corporation incurred fuel expenses of $250.24 and $344.08 for the 240-D and $506.74 and $950.14 for the 450-SL for the years 1978 and 1979, respectively.[22]

Respondent disallowed deductions to the corporation for the personal use percentage of maintenance expenses of $400 each year for the 240-D and $567 and $850, respectively, for the 450-SL. See n.13, supra. The revenue agent determined these figures by calling the largest Mercedes Benz dealer in Oregon to obtain the approximate cost of servicing similar automobiles. Greg Rasmussen, an employee of the dealership, testified at trial that during the years in issue, average routine maintenance expenses for a 240-D during the first 19,000 miles were between $300 and $350, and for the next 17,000 miles were a little higher. Average routine maintenance expenses for a 1975 450-SL for mileage between 15,000 miles and 25,000 miles were between $400 and $600.

(footnote continued from previous page)
issue and reversing on other issues a Memorandum Opinion of this Court; Jasionowski v. Commissioner, supra, 66 T.C. at 318. Here, the evidence of record appears to be more specific, and to a large extent supplements rather than contradicts, the parties' stipulation. We have made our finding based on the record as a whole.

[22] For each vehicle, this is computed by dividing the total mileage each year by the miles per gallon for the particular vehicle times the wholesale price for diesel fuel or gasoline (whichever was applicable) for the year.

Petitioners argue that we should not use average maintenance expenses in determining the corporation's expenses. We agree. Both the 240-D and the 450-SL were under warranty during the years in issue, both warranties were quite extensive, and the automobiles ran basically trouble-free. Moreover, either Mr. Larimore or the corporation's mechanic performed the routine maintenance on the automobiles.

Mr. Larimore reviewed the corporation's records to determine actual maintenance expenditures. We think petitioners' evidence satisfies their burden of proving error in respondent's determination. We think it clear that the corporation tried to minimize its maintenance expenses by having Mr. Larimore or the corporation's mechanic do whatever work had to be done.

Thus, we find the corporation incurred total operating and maintenance expenses for the Mercedes automobiles as follows:

	240-D		450-SL	
Expense	1978	1979	1978	1979
Fuel	$250.24	$344.08	$506.74	$ 950.14
Maintenance	31.95	33.50	88.54	33.72
Insurance	350.00	350.00	400.00	400.00
Total	$632.19	$727.58	$995.28	$1,383.86

The corporation may deduct the business use percentage of these expenses, which amounts to $1,076.01 for 1978 and $1,405.25

for 1979.[23] However, the corporation must reduce these deductions by $600 each year, the reimbursement paid by the Larimores for their personal use.

The corporation is entitled to business expense deductions for the percentage of business use made of the automobiles. *Henry Schwartz Corp. v. Commissioner*, *supra*, 60 T.C. at 744. However, petitioners argue that the corporation is also entitled to deductions for the personal use percentages of depreciation and operating and maintenance expenses because such amounts represent additional compensation to the Larimores. The corporation, of course, can deduct amounts which are paid as compensation so long as such payments (1) do not exceed reasonable compensation for the services actually rendered and (2) are actually intended to be paid purely for the services. Sec. 1.162-7, Income Tax Regs.; *Electric & Neon, Inc. v.*

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[23]

1978

Automobile	Total Expenses		Business Use Percentage		Amount Deductible
240-D	$632.19	x	60%	=	$ 379.31
450-SL	995.28	x	70%	=	696.70
					$1,076.01

1979

Automobile	Total Expenses		Business Use Percentage		Amount Deductible
240-D	$ 727.58	x	60%	=	$ 436.55
450-SL	1,383.86	x	70%	=	968.70
					$1,405.25

Commissioner, 56 T.C. 1324, 1340 (1971), affd. without published opinion 496 F.2d 876 (5th Cir. 1974). Petitioners failed to establish that the corporation intended the Larimores' personal use of the Mercedes automobiles to be compensation to them. Petitioners offered no evidence to this effect, nor did the Larimores report any amounts relating to their personal use of the automobiles on their returns as compensation. On this record, we conclude that the Larimores' personal use of the Mercedes automobiles was clearly not intended to be compensation to them. Absent a showing that the amounts were intended as compensation, they are not deductible by the corporation. *Electric & Neon, Inc. v. Commissioner*, *supra*, 56 T.C. at 1340-1342.

In summary, the corporation is entitled to the following deductions or credit for the Mercedes automobiles:

Item	1978	1979
450-SL as compensation	$17,004.00	$ -0-
240-D depreciation	1,200.00*	1,200.00
Operating & maintenance expenses	1,076.01	1,405.25
Less reimbursements	(600.00)	(600.00)
Total deductions	$18,680.01	$2,005.25
Investment credit--240-D	$574.59**	

*60 percent of $2,000 total depreciation claimed

**$14,364 purchase price x 66.67 percent applicable percentage x 60 percent business use percentage x 10 percent regular percentage

II

Income to the Larimores

The next issue is the amount and character of additional income to the Larimores resulting from their receipt of the 450-SL, their personal use of the 240-D, and the corporation's payment of all operating and maintenance expenses for both Mercedes automobiles.

Compensation Income

Section 61(a) defines gross income as all income from whatever source derived, including compensation for services. Sec. 61(a)(1). As discussed above, the Larimores must include as compensation income for 1978 the purchase price of the 450-SL, $17,004. Consequently, they need not include in their income the fair rental value of the 450-SL. However, since the 450-SL was used for business purposes, the Larimores are entitled to depreciation deductions and an investment credit to the extent of the business percentage. That amounts to depreciation deductions[24] of $1,400 and $2,100 for 1978 and 1979, respectively, and an investment credit[25] of $793.56 for 1978.

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[24] 70 percent x $2,000 = $1,400; 70 percent x $3,000 = $2,100.

[25] $17,004 purchase price x 66.67 percent applicable percentage x 70 percent business use x 10 percent regular percentage = $793.56.

Constructive Dividend Income

Under sections 301(a), 301(c)(1) and 316, a distribution of property made by a corporation to a shareholder generally is includable in the shareholder's gross income as a dividend to the extent of the corporation's earnings and profits.[26] A distribution under section 301 may be found even though the corporation has not formally declared a dividend. Crosby v. United States, 496 F.2d 1384, 1388 (5th Cir. 1974). It is well settled that where corporate property is used by a shareholder or member of his family for personal purposes, not proximately related to the corporate business, the fair rental value of such property is includable in the shareholder's income as a constructive dividend to the extent of the corporation's earnings and profits. Falsetti v. Commissioner, supra, 85 T.C. at 356.

The Court of Appeals for the Ninth Circuit, to which any appeal of this case would lie, has held that the fact that corporate payments are not deductible does not automatically result in constructive dividends to a shareholder. Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1391 (9th Cir. 1977); Falsetti v. Commissioner, supra, 85 T.C. at 356-357. The test for constructive dividends is twofold: Not only must the expenses be nondeductible to the corporation, but they must also represent some economic gain or benefit to the shareholder. *Meridian Wood Products Co., Inc. v. United States*, 725 F.2d 1183, 1191 (9th Cir. 1984); *Palo Alto Town & Country Village, Inc. v. Commissioner*, *supra*, 565 F.2d at 1391. See also *Ireland v. United States*, 621 F.2d 731, 735 (5th Cir. 1980); *Loftin and Woodard, Inc. v. United States*, 577 F.2d 1206, 1215 (5th Cir. 1978); *Ashby v. Commissioner*, 50 T.C. 409, 417-418 (1968). Thus, where a corporation makes a distribution to a shareholder which serves no legitimate corporate purpose and which results in an economic benefit to the shareholder, such benefit constitutes a constructive dividend to the shareholder to the extent of earnings and profits. *Palo Alto Town & Country Village, Inc. v. Commissioner*, *supra*, 565 F.2d at 1391; *Falsetti v. Commissioner*, *supra*, 85 T.C. at 356.

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[26] Petitioners presented no evidence regarding the corporation's earnings and profits. They therefore failed to meet their burden of proving that any distributions the corporation made to the Larimores were not out of the corporation's earnings and profits and thus are not taxable as ordinary dividend income under sections 301(c)(1), 316(a), and 61(a)(7).

We have already determined the nondeductibility of the personal use percentages of the corporation's operating and maintenance expenses for the Mercedes automobiles. Such percentages represent expenses for mileage involved in the Larimores' commuting to and from work and other personal uses of the automobiles. Those percentages of the expenses and the use of the 240-D for personal purposes clearly represent economic benefits bestowed upon the Larimores by the corporation. Thus, the second prong of the constructive dividend test has been satisfied.

We now turn to the question of how much constructive dividend income the Larimores must recognize. They argue that the proper measure of the constructive dividends they received is limited to the amount of the out-of-pocket expense deductions disallowed to the corporation, citing *Rodgers Dairy Co. v. Commissioner*, 14 T.C. 66 (1950). In that case, 14 T.C. at 73-74, however, the Court required a shareholder of the corporate taxpayer to include in income a percentage of the corporate taxpayer's depreciation representing his personal use of a corporate automobile. In some respects *Rodgers Dairy* is an early case decided long before the distinction between actual cost and fair market value was adequately developed. The case nonetheless recognizes that the *value* of corporate property used by a shareholder is the proper measure of income resulting from such use. The Court specifically stated that the personal use percentage of depreciation was includable in income because it was the approximate *value* of the taxpayer's personal use of the car. *Rodgers Dairy Co. v. Commissioner*, *supra*, 14 T.C. at 74. Moreover, it is now well established that the fair rental value of corporate property used for personal purposes is the proper measure of constructive dividends resulting from such use. *Falsetti v. Commissioner*, *supra*, 85 T.C. at 356; *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225, 1240-1242 (1971). There are, however, cases supporting the use of costs as an acceptable measure of value when there is no credible evidence of fair market value or when evidence of fair market value is presented but clearly rebutted. Loftin and Woodard, Inc. v. United States, supra, 577 F.2d at 1222-1223. However, the equation of value with costs is not the norm but the exception. Loftin and Woodard, Inc. v. United States, supra, 577 F.2d at 1223.

In the statutory notice of deficiency to the Larimores, respondent included in their income as constructive dividends $1,488 or $124 per month as the personal use percentage of the fair rental value of the 240-D. Respondent's determination is presumptively correct, and the Larimores bear the burden of proving error therein. Welch v. Helvering, supra; Rule 142(a). The Larimores presented no evidence of the 240-D's fair rental value. To support his determination of the 240-D's fair rental value, respondent presented the testimony of Greg Rasmussen, an employee of the largest Mercedes Benz automobile dealer in the State of Oregon. Mr. Rasmussen testified, and we found as a fact, that during the years in issue, a new 1978 240-D cost between $280 and $290 per month to lease. Forty percent of such amounts produce a leasing cost for the Larimores' personal use of the 240-D of between $112 and $116 per month. These figures are close to respondent's determination of $124 per month, but we will reduce the figure to $116. Thus, we sustain respondent's determination to the extent of $1,392 as constructive dividends for each year in issue, representing the 240-D's fair rental value. This amount is exclusive of operating and maintenance expenses.

Respondent also included in the Larimores' income as constructive dividends the amount of operating and maintenance expense deductions disallowed to the corporation. The personal use percentages of the expenses paid by the corporation represent additional economic benefits to the Larimores, and therefore constitute constructive dividends to them, in the total amounts of $551.46 for 1978 and $706.19 for 1979.[27] However, the Larimores may reduce their constructive dividend income by the $600 they reimbursed the corporation each year for their personal use of the Mercedes automobiles.

In summary, the Larimores must include in income and may deduct the following:

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[27] See n.23, *supra*. The Larimores' constructive dividend income is the 40 percent and 30 percent usage disallowed to the corporation for each vehicle:

	1978	1979
240-D	252.88	291.03
450-SL	298.58	415.16

Item	1978		1979
Compensation			
450-SL purchase price	$17,004.00	$17,004.00	-0-
Constructive dividends			
240-D fair rental value	$ 1,392.00		$1,392.00
Operating and maintenance expenses paid by the corporation	551.46		706.19
		1,943.46	
Total		$18,947.46	$2,098.19
Deductions			
Depreciation--450-SL	(1,400.00)		(2,100.00)
Reimbursements to corporation	(600.00)		(600.00)
Total		(2,000.00)	(2,700.00)
Investment credit--450-SL	(793.56)	(793.56)	-0-

The Larimores may also be entitled to dividerd exclusions as provided in section 116.

To reflect the foregoing,

Decisions will be entered under Rule 155.

JU 11.7/2: 1986-327

T. C. Memo. 1986-327

UNITED STATES TAX COURT

MICHAEL B. and SARA L. HERNANDEZ, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9436-83. Filed July 29, 1986.

During 1977, 1978, and 1979, P transferred funds to MARRES, a tax-exempt organization of which he was the founder and executive director. P had complete control over such funds and some were used to pay for P's subscriptions, dues, real estate training course, and loans.

Held: (1) P's claimed contributions are not deductible since P has retained dominion and control over MARRES' funds, and some of such funds have inured to P's benefit.

(2) P has failed to introduce any evidence to carry his burden of proving that the underpayments were not due to negligence or intentional disregard of rules and regulations within the meaning of sec. 6653(a), I.R.C. 1954.

ORIGIN

C.M.

Frank P. Hernandez, for the petitioners.

Deborah A. Butler, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SIMPSON, *Judge*: The Commissioner determined deficiencies in, and additions to, the petitioners' Federal income taxes as follows:

		Additions to Tax	
Year	Deficiency	Sec. 6651(a) I.R.C. 1954[1]	Sec. 6653(a) I.R.C. 1954
1977	$11,527.85	$ 350.73	$ 845.89
1978	14,449.13	1,526.16	765.46
1979	18,732.88	3,549.87	1,232.49

The issues remaining for decision are: (1) whether the petitioners have adequately substantiated the charitable deductions claimed by them for 1977, 1978, and 1979; (2) whether the funds of the donee organization inured to the benefit of the petitioner; and (3) whether the petitioners are liable for the addition to tax pursuant to section 6653(a) for such years.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners, Michael B. and Sara L. Hernandez, maintained their legal residence in Duncanville, Tex., at the time of filing their petition in this case. They filed joint Federal income tax returns for 1977, 1978, and 1979 with the Internal Revenue Service Center, Austin, Tex. Mr. Hernandez will sometimes be referred to as the petitioner.

Mr. Hernandez founded the Mexican American Research, Resource, and Educational Services, Inc. (MARRES), in 1969. On October 12, 1970, MARRES was determined to be exempt from Federal income tax under section 501(c)(3). MARRES was organized for educational, scientific, charitable, and public service purposes. The articles of incorporation, as amended, provided in part:

> This organization is dedicated in addition to the above, through the implementation of positive programs, and by establishing channels for the interchange of information, to the stimulation of youth towards public service, productive and worthy goals, to lessesing [sic] the burdens of government, lessening of neighborhood tensions, elimination of prejudice and discrimination, combating of community and environmental deterioration and juvenile delinquency and for the stimulation of more active citizenship.

The petitioner has been the executive director of MARRES since its inception. Prior to 1977, MARRES received no donations, and the petitioner has been the sole source of any contributions thereafter. Apparently, the petitioner was unable to locate individuals interested in making contributions to MARRES so it was not until September 1981 that MARRES began its first charitable activity. At that time, in cooperation with the Development Office at the University of Texas at Austin, a graduate fellowship was established with monies from MARRES. Although MARRES expended no funds to the fellowship prior to such time, the organization's goal had been to establish a fellowship at the University. It was the petitioner's belief that MARRES needed $25,000 to establish it. When he was informed that there was an extended plan, which enabled smaller donations to be made until the goal of $25,000 was reached, MARRES became involved.

In 1975, the petitioner founded the League for Equal Opportunity Now (LEON), which the IRS held not to be exempt from taxation. The petitioner has been the president of LEON since its inception, and it is clear from the record that he has always had complete control over LEON. The sole purpose of LEON was to "implement programs" through the use of monies contributed to MARRES and then transferred to LEON. There is no evidence that LEON ever implemented any charitable programs.

During the years at issue, the petitioner maintained bank accounts with the First National Bank of Duncanville, under his sole signatory authority, in the name of MARRES and LEON. The account in MARRES name shows deposits of $2,000 for 1977, $10,700 for 1978, and $5,500 for 1979. After such deposits had been made, the petitioner transferred $12,700 to the LEON account. Subsequently, $8,500 was transferred from the LEON account into the petitioner's personal account at the Federal Credit Union. The petitioner believed that MARRES could not open an account at the Federal Credit Union, and it is his position that the purpose of such transaction was to earn a higher interest rate for MARRES. The interest earned on the money at the Federal Credit Union was reported on the petitioners' personal tax returns. Apparently in 1981, the petitioner returned this money, together with interest, to MARRES. Analysis of the checks and stubs for the LEON account establishes that the petitioner utilized such funds for subscriptions and dues ($97.75); a loan for a real estate training course ($495.00); and payment on the petitioner's personal loan with the Government Agencies Dallas Federal Credit Union ($1,200).

On their Federal income tax returns, the petitioners claimed deductions for charitable contributions of $3,352.00 in 1977, $7,389.00 in 1978, and $6,004.05 in 1979. In 1977, these claimed contributions included a $2,000 donation to MARRES and $1,352 for contributions made to public organizations such as United Fund, Red Cross, and the Dallas Police Association. The 1978 contributions included $6,400 to MARRES and \$989[2] to other organizations. For 1979, no such breakdown was given on the petitioners' Federal income tax return. In the notice of deficiency, the Commissioner determined that the petitioners' deductions for charitable contributions for the years at issue were not allowable because the amounts or the deductibility had not been adequately substantiated. The Commissioner also determined that the petitioners were liable for each of the years for the addition to tax under section 6651(a) for having filed an untimely return and the addition to tax under section 6653(a) for an underpayment of tax due to negligence or intentional disregard of rules and regulations. The petitioners now concede that they are liable for the addition to tax under section 6651(a) for each year.

OPINION

The first issue for decision is whether the petitioners can deduct charitable contributions of \$3,352.00 in 1977, \$7,389.00 in 1978, and \$6,004.05 in 1979. On their Federal income tax returns, the petitioners claimed portions of these amounts as contributions to public organizations, such as the Red Cross and United Fund. However, the petitioners have offered no testimony, receipts, or other evidence concerning any of the contributions to public organizations. Consequently, we infer that they have abandoned any claim for deductions for contributions to the public organizations.

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[2] Apparently the petitioner made a mathematical error in his total when he added his claimed contributions and transferred them to his tax return for 1978; his list totals \$7,399, but he only claimed \$7,389 as contributions. This error has no effect on our decision.

The petitioners have argued at trial and on brief that they are entitled to the deductions claimed by them as contributions to MARRES. Deductions are a matter of legislative grace, and taxpayers must satisfy the specific statutory requirements applicable to the deductions claimed by them. Deputy v. DuPont, 308 U.S. 488 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). Charitable contributions cannot be deducted unless they are made to organizations described in section 170(c). Sec. 170(a). Pursuant to section 170(c), the petitioners' contributions to MARRES are not deductible unless it was organized and operated exclusively for charitable purposes and no part of its net earnings inures to the benefit of any private individual. The crux of the Commissioner's position is that the petitioner has maintained control of MARRES and that the alleged contributions have inured to the petitioner's benefit. The petitioner contends that he has not received any benefits from MARRES. The burden of proof rests with the petitioners. Rule 142(a), Tax Court Rules of Practice and Procedure; Welch v. Helvering, 290 U.S. 111 (1933).

An organization is operated "exclusively" for exempt purposes if its activities primarily serve one or more exempt purposes and not, except to an insubstantial degree, a nonexempt purpose. Canada v. Commissioner, 82 T.C. 973, 980 (1984); sec. 1.501(c)(3)-1(c)(1), Income Tax Regs. The existence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Better Business Bureau v. United States, 326 U.S. 279, 283 (1945); see also Canada v. Commissioner, supra; Nat. Assn. of American Churches v. Commissioner, 82 T.C. 18, 28-29 (1984).

An organization is not operated exclusively for exempt purposes unless it is operated for the benefit of the public rather than for the benefit of a private interest. Church of the Transfiguring Spirit v. Commissioner, 76 T.C. 1, 5 (1981). The statute also requires that no part of the net earnings of the charitable organization inure to the benefit of any private individual. Sec. 170(c)(2)(C). Even if the benefit inuring to the members is small, it is still impermissible. McGahen v. Commissioner, 76 T.C. 468, 482 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church v. Commissioner, 74 T.C. 507, 513 (1980), affd. without published opinion 647 F.2d 163 (2d Cir. 1981). The phrase "net earnings" includes more than mere net profits, and benefits may inure to private individuals other than through the distribution of dividends. Canada v. Commissioner, 82 T.C. at 981; Unitary Mission Church v. Commissioner, 74 T.C. at 512-513.

Additionally, the term "charitable contribution," as it is used in section 170, is largely synonymous with the term "gift." Davis v. Commissioner, 81 T.C. 806, 817 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985); Seed v. Commissioner, 57 T.C. 265, 275 (1971); Wolfe v. Commissioner, 54 T.C. 1707, 1713 (1970); DeJong v. Commissioner, 36 T.C. 896, 899 (1961), affd. 309 F.2d 373, 376-379 (9th Cir. 1962). A gift is generally defined as a voluntary transfer of property to another without consideration. Retained control and personal benefits preclude a finding of a gift. Davis v. Commissioner, supra.

The petitioner's retained dominion and control of MARRES' funds, and the personal benefits derived from such funds, precludes a finding of any charitable contributions within the meaning of section 170. The record clearly establishes that the petitioner retained control over the funds transferred to MARRES and then to an account in the name of LEON. The petitioner has always had complete control over both MARRES and LEON. Not only has he been the executive director of MARRES and president of LEON since their inception, but he has had sole signatory authority over both of the accounts. Additionally, an analysis of the checks and stubs for the LEON account establishes that the petitioner utilized such funds for subscriptions and dues, a real estate training course, and payment on the petitioner's personal loan with the Government Agencies Dallas Federal Credit Union. No evidence whatsoever has been offered to show us that these uses do not constitute benefits inuring to the petitioner. Thus, the petitioner has utterly failed to carry his burden of proving that the funds transferred to MARRES constitute charitable contributions; therefore, the petitioners' claimed contributions are not deductible.

We must also decide whether any part of the deficiencies due from the petitioners is attributable to their negligence or intentional disregard of rules and regulations within the meaning of section 6653(a). Under this section, negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985). The petitioners have the burden of proving they were not negligent. Neely v. Commissioner, supra; Bixby v. Commissioner, 58 T.C. 757, 791 (1972); Inter-American Life Insurance Co. v. Commissioner, 56 T.C. 497, 512 (1971), affd. per curiam 469 F.2d 697 (9th Cir. 1972). The petitioners have failed to introduce any evidence to carry their burden. Indeed, the petitioners struck us as reasonably intelligent, well educated individuals; they must have known that some record of their claimed contributions would be required. However, no such evidence has been provided to us. Furthermore, no reasonable person could have believed that amounts channeled through MARRES and LEON to their own bank account and amounts used for their own personal benefit could qualify as charitable contributions. On the basis of this record, we hold that the petitioners have failed to carry their burden of showing that the underpayments of tax were not due to negligence or intentional disregard of rules and regulations.

Decision will be entered
under Rule 155.

JU11.7/2: 1986-328

742-B

322

T. C. Memo. 1986-328

ME 204

UNITED STATES TAX COURT

ERICH MEYER and ILSE M. MEYER, Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

DONALD F. COX, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 6667-78, 10169-78. Filed July 30, 1986.

Talmud Properties Partnership[1]

Nancy V. Powell, for the petitioners.

Barbara M. Leonard, for the respondent.

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[1] The case of P. Michael Hunt and Sherry L. Hunt v. Commissioner, docket No. 13386-80, was originally consolidated with these cases, but all issues in the Hunt case have been settled.

C.M

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, Judge: Respondent determined deficiencies in petitioners' Federal income tax and additions to tax under section 6653(a)[2] for the taxable year 1974 in the following amounts:

Petitioners	Year	Deficiency in Income Tax	Addition to Tax I.R.C. 1954 Section 6653(a)
Erich Meyer and Ilse M. Meyer	1974	$457,420	$22,871
Donald F. Cox	1974	66,305	3,315

The issue for decision is whether petitioners are entitled to deduct on their 1974 income tax returns amounts claimed as distributive losses from Talmud Properties Partnership, which distributive losses resulted entirely from an interest deduction claimed on the partnership's 1974 return of income. This case is before us on this severed issue only.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Erich Meyer and Ilse M. Meyer, husband and wife, who resided in San Francisco, California, at the time their petition in this case was filed, filed a joint Federal income tax return for the calendar year 1974. Donald F. Cox, who resided in Tiburon, California, at the time his petition in this case was filed, filed an individual Federal income tax return for the calendar year 1974.

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[2] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the year here in issue.

The signatures of Erich Meyer and Donald F. Cox, along with the signatures of P. Michael Hunt, Werner Erhard, Anglo Dutch Capital Co. (ADC), a California corporation, by Harry Margolis, president, Erhard Seminars Training, Inc. (EST) by K. Laurel Scheaf, president, and Gerald L. Schulman appear on a document stated to be a "Partnership Agreement." Messrs. Meyer, Cox, Hunt, Erhard and Schulman were clients of Mr. Harry Margolis, and EST was a client of Mr. Margolis. Mr. Harry Margolis is the sole owner of ADC. The statements in this document are to the effect that Talmud Properties Partnership (Talmud) is organized as a general partnership consisting of the individuals and entities whose signatures appear on the instrument. The records maintained in Mr. Harry Margolis' office for Talmud show the following amounts received as contributions from the partners indicated:

Gerald Schulman	$ -0-
P. Michael Hunt	-0-
Erich Meyer	500,000
Donald F. Cox	80,000
EST	250,000
ADC	100,000
Werner Erhard	70,000
Total	$1,000,000

The bank records and other records of Talmud and of Antigua Banking Limited (ABL), an Antigua company the stock of which was owned by a New Hebrides company and which was directed and managed by Mr. Margolis, show that on December 2, 1974, $70,000 was transferred from ABL's account at Barclays Bank California to Werner Erhard's account at that bank, $80,000 was transferred from ABL's account at Barclays Bank California to Donald F. Cox's account at that bank, and $250,000 was transferred from ABL's account at Barclays Bank California to EST's account at that bank. The records show that on December 2, 1974, $80,000 was transferred from Donald F. Cox's account at Barclays Bank California, $70,000 from Werner Erhard's account at that bank, $250,000 from EST's account at that bank, and $500,000 from Erich Meyer's account at that bank to Talmud's account at Barclays Bank California. The record further shows a transfer to Talmud's account at Barclays Bank California of $100,000 from an undisclosed source. The record further shows that on December 2, 1974, $1 million was transferred from Talmud's account at Barclays Bank California to ABL's account at that same bank. The record of ABL shows that the $1 million transferred to its bank account at Barclays Bank California is entered on its records as interest paid.

A document entitled "Agreement to Purchase and Finance Properties" stated to be between Talmud and World Entertainers (WE), a foreign entity originally organized at the request of Mr. Harry Margolis, dated November 18, 1974, bears the signature of Talmud by Gerald L. Schulman and

Donald F. Cox and the signature of WE by Lee Bing Chuen. Donald F. Cox's signature is dated "4/14/76." This document recites that Talmud will lend $10 million to WE interest-free for 1 year in exchange for a commitment by WE to provide to Talmud over a period of 5 years $30 million of financing at 5 percent. The document further recites the type of properties which may be involved in the financing, namely properties that have a long-term lease with a recognized tenant, such as a United States Post Office, with a fixed rental payment. The agreement further recites that for each property that meets the criteria set forth in the document submitted by Talmud to WE, WE will pay 1 percent of the value of the property to Talmud and if the property is accepted for financing, will pay 5 percent of its value to Talmud. The bank records of Talmud and ABL at Barclays Bank California show the following series of transfers on December 6, 1974:

From	To	Amount	Bank Charge
ABL	Talmud	$ 100,000	-0-
Talmud	ABL	100,000	-0-
ABL	Talmud	1,000,000	-0-
Talmud	WE	1,000,000	$25

On December 6, 1974, the following amounts were transferred to ABL's account at Barclays Bank California from Barclays Bank Tortola:

From	To	Amount
Barclays Bank Tortola	ABL	$ 901,000
Wickhams Cay Trust Co.	ABL	1,050,000

Wickhams Cay Trust Co. is a trust company registered in the British Virgin Islands. It was formed in 1974 and Noel Barton is registered as its director. Wickhams Cay Trust Co. has a minimal net worth in its own right.

On December 9, 1974, the following transfers to and from the accounts of Talmud and ABL from their bank accounts at Barclays Bank California are shown by their records and the records of Barclays Bank California:

From	To	Amount
ABL	Talmud	$ 100,000
Talmud	ABL	100,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000
ABL	Talmud	550,000
Talmud	ABL	50,000
Talmud	WE	500,000
ABL	Talmud	550,000
Talmud	ABL	50,000
Talmud	WE	500,000
ABL	Talmud	550,000
Talmud	ABL	50,000
Talmud	WE	500,000
ABL	Talmud	100,000
Talmud	ABL	100,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000
ABL	Talmud	100,000
Talmud	ABL	100,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000

The bank records of ABL at Barclays Bank California for December 9, 1974, show the following series of transfers to ABL's account from a nominee's account at Barclays Bank Tortola:

Transfers
From Nominee's Account
To ABL's Account

$901,000	$250,000
900,000	150,000
901,000	694,000
900,000	694,000
901,000	568,000
900,000	600,000
901,000	855,000
900,000	601,000
901,000	701,000
485,000	711,000
	650,000

The primary source of funds for ABL was WE.

The bank records at Barclays Bank California of Talmud and ABL show the following series of transfers to and from those accounts on December 20, 1974:

From	To	Amount
ABL	Talmud	$ 50,000
Talmud	ABL	50,000
ABL	Talmud	500,000
Talmud	WE	500,000
ABL	Talmud	100,000
Talmud	ABL	100,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000
ABL	Talmud	100,000
Talmud	ABL	100,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000
ABL	Talmud	200,000
Talmud	ABL	200,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000
ABL	Talmud	1,000,000
Talmud	WE	1,000,000

The bank records of ABL at Barclays Bank California show the following transfers to ABL's account from a nominee's account at Barclays Bank Tortola on December 20, 1974:

Transfers
From Nominee's Account
To ABL's Account

$ 945,000	$ 600,000	$ 300,000
150,000	950,000	150,000
1,000,000	850,000	150,000
1,000,000	150,000	410,000
1,000,000	650,000	580,000
1,000,000	900,000	1,000,000
1,000,000	100,000	500,000
1,000,000	500,000	1,000,000
1,000,000	600,000	450,000
1,000,000	350,000	450,000
1,000,000	350,000	990,000
1,000,000	550,000	10,000
349,000	250,000	10,000

The bank records of Talmud at Barclays Bank California show the following series of transfers to and from that account on December 9, 1975:

From	To	Amount
WE	Talmud	$1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000
WE	Talmud	1,000,000
Talmud	Barclays BVI	1,000,000

From prior to 1969 through at least 1976, employees in Mr. Harry Margolis' office would prepare "cash flow" or "money movement" charts. These charts would show where money was to go. The employee would also prepare an "authorization form" for each transfer of funds. Money would often go out of and come back into the same account on the same day. There was a box on the authorization form entitled "Circulating." When funds were to stay within the Margolis "system" this box would be checked. The Margolis "system" consisted of entities both foreign and domestic which were in some way connected with Mr. Harry Margolis' office, either as clients or entities whose books were kept in his office and for which he could issue authorization forms to the bank for transfer of funds.

In late 1973, Mr. Margolis met Gerald Schulman. At the time, Gerald Schulman was organizing limited partnerships to acquire properties which were occupied by a credit-worthy tenant on a long-term lease paying a sufficient rental for the loan on the property to be paid from rental receipts. Mr. Schulman considered such properties appropriate to be placed in a limited partnership to be formed by him. Mr. Schulman would acquire a contract to purchase the properties so that he could transfer them to a limited partnership. These properties were referred to by Mr. Schulman as "Post Office properties" since the tenants in many of the buildings that he acquired were United States Post Offices. One of the provisions of the Talmud partnership agreement which Mr. Schulman signed as a general partner was that any property suitable for syndication acquired by a partner in that partnership must be offered to the partnership in writing at identical terms as the terms of acquisition by the partner.

In addition to the formation of the Talmud partnership, Mr. Margolis also prepared and had signed similar partnership agreements for partnerships designated as Koran, Isis and Zen. The partnership agreement for each of these partnerships also provided that any property suitable for syndication acquired by a partner must be offered to the partnership at identical terms to the terms of its acquisition by the partner. An agreement was signed on behalf of each of these partnerships with WE identical to the financing agreement signed on behalf of WE and Talmud. Each of the agreements signed on behalf of WE and one of the partnerships of Koran, Isis or Zen contained identical terms to the agreement between Talmud and WE, that is, that a stated amount of money would be lent by the partnership to WE, interest-free, and that WE would pay to the partnership 1 percent of the cost of properties offered to it by the partnership and 5 percent of the cost if the property was accepted by it. Each of the agreements with the partnerships other than Talmud provided for making available loans of a specified sum of money by WE for the partnership at an interest rate of 5 percent. Gerald Schulman is listed as a general partner in each of the Koran, Isis and Zen partnerships. Erich Meyer, Donald F. Cox, EST, ADC and P. Michael Hunt are listed as partners of Koran. P. Michael Hunt is listed as a partner of Isis.

The following schedule shows properties acquired by Mr. Schulman, the acquisition price and the partnership or partnerships to which they were offered, together with the percentage offered to that partnership as contained in records in Mr. Harry Margolis' office:

Location of Property	Purchase Price	Partnersnip to Which Offered	Percentage Offered
South Broadway, Los Angeles, CA	$185,000.00	Talmud	100
Nevada City, CA	234,094.50	Talmud	100
Salt Lake City, Utah	403,000.00	Talmud	50
Salt Lake City, Utah	403,000.00	Koran	50
Henry, Illinois	164,500.00	Talmud	100
Fremont, CA	650,000.00	Talmud	50
Fremont, CA	650,000.00	Koran	50
Cambrian Park, San Jose, CA	595,000.00	Talmud	33
Cambrian Park, San Jose, CA	595,000.00	Koran	33
Cambrian Park, San Jose, CA	595,000.00	Isis	33

Talmud did not seek to enforce the provision of the partnership agreement giving it the exclusive right to properties acquired by any partner against Gerald Schulman.

A partner of Talmud, on behalf of Talmud, signed documents designated as promissory notes in favor of ABL. These documents show the following numbers, dates, and amounts:

Number	Date	Amount
915	12/5/74	$1,000,000
129	12/9/74	2,000,000
951	12/9/74	2,500,000
960	12/19/74	4,500,000

These documents recite that prepayment of 10 percent interest is required on the amount stated to be the loan. Documents stating the assignment of the above described notes, dated approximately 2 months after the date appearing on the notes, state that the notes are assigned to Barclays Bank Tortola without warranty on the part of ABL. The assignment of the notes to Barclays Bank Tortola was for the account of Wickhams Cay Trust Co. Noel Barton, as director of Wickhams Cay Trust Co., did not ask for or receive any information regarding the financial status of Talmud or any of its partners prior to the transfer of funds to ABL, purportedly under the later executed assignment of the notes without warranty. In 1974 and 1975, Mr. Barton was a signator on the bank account of WE at Barclays Bank Tortola.

There was prepared in the office of Mr. Harry Margolis a document entitled "Commission Schedule" for each Talmud, Koran, Isis and Zen partnership for the year 1974. According to this document each of these partnerships offered WE in the year 1974 properties having the following value:

Partnership	Amount
Talmud	$2,401,333
Koran	2,044,833
Isis	1,448,083
Zen	1,270,000

According to the commission schedules prepared in the office of Mr. Harry Margolis, the following properties from the partnerships shown were accepted by WE under the terms of the agreement to purchase and finance properties during the period of 1975, ending November 30:

Partnership	Amount
Talmud	$730,194.25
Koran	730,194.25
Isis	730,194.25
Zen	730,194.25

The agreement to purchase and finance properties between Talmud and WE, and also the agreement between Koran and WE, provided that WE would accept properties from each of these partnerships at a value of not less than the following amounts:

Year	Amount
1975	$4,000,000
1976	5,000,000
1977	7,000,000
1978	9,000,000

The agreement to purchase and finance properties between Isis and WE states that WE would accept properties from Isis suitable for syndication having a value of not less than the following amounts:

Year	Amount
1975	$2,000,000
1976	4,000,000
1977	6,000,000
1978	8,000,000

There was no requirement in the agreement between Koran and WE, or Isis and WE, that WE accept any properties in 1974, but if it did, it was to pay the stated 5 percent commission. Also under the agreement, WE would pay 1 percent of the purchase price to each Isis and Koran for each property offered during the year 1974.

In December 1975, documents were prepared and signed stating that Koran, Isis, Zen and Talmud were consolidated into a partnership entitled KIZT. According to the documents, each of the agreements to purchase and finance properties between each partnership and WE were incorporated into the consolidation. The documents provided that KIZT would lend to a Panamanian corporation, Parallax, an entity which was part of the Margolis system, interest-free for 1 year a specified sum of money, and Parallax was to take over the agreement between each of the partnerships going into the consolidation of KIZT and WE with respect to financing properties.

The escrow opened on November 26, 1974, by Gerald Schulman with respect to the South Broadway property in Los Angeles, California, showed the total sales price of the property to be $185,000 with a downpayment of $38,000 and an assumable first deed of trust with an unpaid balance in the amount of approximately $147,000 as of November 1974 at 5-1/2 percent interest per annum. This trust deed required annual payments of $16,220.04 until February 1987. The escrow substitution agreement dated December 6, 1974, between Gerald Schulman and Talmud states that Mr. Schulman assigned his rights in the escrow on the South Broadway property to Talmud. A document showing an assignment from Talmud to Convalescent Rehabilitation Center Services, Inc. (CRC), a California corporation of which Regina Leary, an attorney in Mr. Harry Margolis' law office from 1974 through 1976, was president, and Kenneth Reiserer, another attorney in Mr. Margolis' office, was assistant secretary and treasurer, of Talmud's rights in the escrow on the South Broadway property was dated December 6, 1974. Neither Mrs. Leary nor Mr. Reiserer received a salary from CRC for acting as its officers. Mrs. Leary had no experience in corporate management before becoming president of CRC. Policy decisions for CRC were made in Mr. Margolis' office and during the time Mrs. Leary was president of CRC, the original books of entry of CRC were kept in Mr. Margolis' office.

The agreement of limited partnership of South Broadway Limited (Post Office Partnership No. 1) dated December 31, 1974, states that the total capital contribution of the partners to Post Office Partnership No. 1 is $72,000. There is a document signed on behalf of Post Office Partnership No. 1 and CRC stating that it is a sales agreement between Post Office Partnership No. 1 and CRC. Under the statements in this document, Post Office Partnership No. 1 agrees to purchase a post office located at South Broadway in

Los Angeles, California, for $289,000 cash. The document further states that CRC has arranged for long-term financing of the property in the amount of $289,000 from WE. The document further states that the financing required Post Office Partnership No. 1 to deposit $720,000 with WE in 1974 for 1 year interest-free. The document further states that CRC would arrange for a 1-year loan from ABL to Post Office Partnership No. 1 in the amount of $720,000 for which Post Office Partnership No. 1 would pay ABL $72,000 in interest. There is a document entitled "Financing Agreement" between WE and Post Office Partnership No. 1 dated December 1974 and a document entitled "Negotiable Promissory Note" in favor of WE from Post Office Partnership No. 1 dated December 6, 1974. The document entitled "Financing Agreement" stated that WE would lend $289,000 to Post Office Partnership No. 1 at an effective interest rate of approximately 5 percent over the terms of the loan and the document entitled "Negotiable Promissory Note" was for the amount of $289,000.

These documents state that from December 6, 1974 through December 1979, interest was to be computed at 5.63 percent per annum, and from January 1, 1980 through December 31, 1986, interest was to be computed at 4.2 percent per annum, and from January 1, 1987, all payments on the loan were to be applied to principal only until the loan was repaid. The annual payments under the loan were to be $16,260 from December 6, 1974, to January 1, 1987, and

$16,900 thereafter. If all payments on the deed of trust which was on the South Broadway post office property when it was acquired by Mr. Schulman had been timely made, the property would have been unencumbered by January 31, 1987, with a final payment of $6,540.90. If all payments under the agreement between CRC, WE and Post Office Partnership No. 1 were timely made, the property would be unencumbered on January 31, 2002.

On December 9, 1974, Gerald Schulman opened an escrow on a post office property located in Nevada City, California. Under the terms of the escrow, the total purchase price of the property was $235,094.50, consisting of a downpayment of $58,000 and an assumable first deed of trust at 7.36 percent per annum with an unpaid balance as of December 1974 in the amount of $177,094.50. The deed of trust was payable over a 20-year period commencing January 1, 1973. Under the terms of the first deed of trust on the Nevada City post office property, if all payments were timely made, the property would be unencumbered by January 1, 1993. Payments on the Nevada City property under the assumed deed of trust were at $1,427.92 a month or $17,135.04 a year, with a final payment due December 31, 1992, of $25,350.04.

A document entitled "Escrow Substitution Agreement" between Mr. Schulman and Talmud dated December 24, 1974, states that Mr. Schulman transfers his rights in the escrow on the Nevada City post office property to Talmud. There is an assignment agreement dated December 6, 1974, from Talmud to CRC stating that Talmud assigned its rights in the escrow on the Nevada City post office property to CRC.

A document entitled "Agreement of Limited Partnership" of Nevada City Limited (Post Office Partnership No. 2) dated December 31, 1974, states that the total capital contribution to Post Office Partnership No. 2 is $85,000. A document entitled "Post Office Sales Agreement" between CRC and Post Office Partnership No. 2 dated in December 1974 states that Post Office Partnership No. 2 is to purchase the post office property located at Nevada City, California, for $315,000 cash. The document further states that CRC has arranged for long-term financing for Post Office Partnership No. 2 from WE in the amount of $315,000 and that the financing package requires Post Office Partnership No. 2 to deposit $790,000 with WE in 1974 for 1 year interest-free. The document further states that CRC would arrange for Post Office Partnership No. 2 to borrow $790,000 from ABL for 1 year at 10 percent interest or $79,000. A document entitled "Financing Agreement" between WE and Post Office Partnership No. 2 dated in December 1974 recites that WE and Post Office Partnership No. 2 have an arrangement whereby WE would lend $315,000 to Post Office Partnership No. 2 at an effective interest rate of 5 percent. A promissory note to WE from Post Office Partnership No. 2 recites a loan of $315,000.

These documents state that from December 1974 through December 31, 1979, payments were to be applied to interest on the loan computed at the rate of 5.44 percent per annum and from January 1, 1980 through December 31, 1981, payments were to be applied to interest on the loan computed at a rate of 4.5 percent per annum, remainder to principal. From January 1, 1992, payments were to be applied to principal only until the loan was repaid. Annual payments on the loan were to be $17,135 from December 1974 through December 31, 1992, and $25,000 per annum thereafter until the note was paid. If all payments under this agreement were timely made, the note would be repaid in the year 2003.

On October 14, 1974, Gerald Schulman opened an escrow on a post office property located in Salt Lake City, Utah. Escrow instructions were amended on December 18, 1974, and again on December 26, 1974. Under the terms of the escrow, the total purchase price of the property was to be $393,000, consisting of a downpayment of $68,000 and an assumable all-inclusive deed of trust with an unpaid balance in the approximate amount of $323,000 as of October 1974. The all-inclusive deed of trust bore interest at a rate of 7.77 percent per annum and required annual payments in the amount of $31,605. The term of the deed of trust was approximately 23 years and 1 month. The escrow instructions called for payments of brokerage by the purchaser in the amount of $10,000. Under the terms of the deed of trust, if all payments were timely made, the Salt Lake City post office property would have been unencumbered on April 30, 1995.

A document entitled "Escrow Substitution Agreement" dated December 24, 1974, stated that Mr. Schulman transferred his rights in the escrow on the Salt Lake City post office property to Talmud and Koran. According to the escrow substitution agreement, each partnership received 50 percent of Mr. Schulman's rights in the escrow. Documents entitled "Assignment" between Talmud and CRC and Koran and CRC dated December 6, 1974, stated that Talmud and Koran each transferred their rights in the escrow on the Salt Lake City property to CRC.

A document entitled "Agreement of Limited Partnership" for the Salt Lake City property (Post Office Partnership No. 4) dated December 31, 1974, states that the total capital contribution to Post Office Partnership No. 4 is $130,000. A document entitled "Post Office Sales Agreement" between Post Office Partnership No. 4 and CRC states that Post Office Partnership No. 4 buys the Salt Lake City post office property from CRC for $520,000 cash. The agreement further states that CRC would arrange long-term financing for Post Office Partnership No. 4 from WE in the amount of $520,000. The document states that the financing package would require Post Office Partnership No. 4 to deposit $1,300,000 with WE in 1974 for 1 year interest-free. The agreement also states that CRC will arrange for Post Office Partnership No. 4 to borrow $1,300,000 from ABL for 1 year at 10 percent interest or $130,000. The document entitled "Financing Agreement" between Post Office Partnership No. 4 and WE dated in December 1974 and a promissory note from Post Office Partnership No. 4 dated December 9, 1974, recites that WE would lend Post Office Partnership No. 4 $520,000 at an effective interest rate of 5 percent for approximately 30 years.

These documents state that from December 1974 through December 31, 1979, payments were to be applied to interest computed at the rate of 6.08 percent and payments from January 1, 1980 through December 31, 1995 were to be applied to interest to be computed at an annual rate of 5 percent with the remaining amount being applied to principal. From January 1, 1996, payments were to be applied to principal only until the balance of the loan was paid off. Annual payments were to be $31,605 from December 9, 1974, until the loan was repaid. Under the agreement entitled "Financing Agreement" between WE and Post Office Partnership No. 4, if all payments were timely made the note would be paid off in full in the year 2008.

On December 10, 1974, Gerald Schulman opened an escrow on a post office property located in Henry, Illinois. The escrow closed on June 6, 1975. Under the terms of the escrow, the total purchase price of the property was to be $146,500 consisting of a downpayment of $29,300 and a deed of trust in the amount of $117,200 at a rate of 7 percent per annum requiring an annual payment of $10,850.14. Payments on the trust deed were to commence in April 1975 and continue for 15 years. Under the terms of the trust deed, if all payments were timely made, the Henry, Illinois, post office property would be unencumbered in 1990 with a final payment of $47,308.67 being made on March 1, 1990.

A document entitled "Escrow Substitution Agreement" dated December 24, 1974, between Gerald Schulman and Talmud states that Mr. Schulman assigned his interest in the escrow on the Henry, Illinois, post office property to Talmud. A document dated December 6, 1974, entitled "Assignment" from Talmud to CRC states that Talmud assigns its interest in the escrow on the Henry, Illinois, post office property to CRC.

An agreement of limited partnership of Henry Limited (Post Office Partnership No. 5) dated December 20, 1974, states that the total capital contribution of the partners to the Post Office Partnership No. 5 is $50,000. A sales agreement dated December 1974 from CRC to Post Office Partnership No. 5 states that Post Office Partnership No. 5 is to purchase the Henry, Illinois, post office property from CRC for $194,000 cash. The agreement states that CRC would arrange for long-term financing of Post Office Partnership No. 5 from WE in the amount of $194,000 cash. It further states that Post Office Partnership No. 5 is to deposit $500,000 with WE in 1974 interest-free for 1 year, and that

CRC would arrange for Post Office Partnership No. 5 to borrow $500,000 from ABL for 1 year at 10 percent interest or $50,000. As in the other instances, there is a financial agreement between Post Office Partnership No. 5 and WE providing for financing in the amount of $194,000 with an effective interest rate of 5 percent and a promissory note from Post Office Partnership No. 5 to WE providing for payment in approximately 20 years. These documents also provide for interest only payments of 5.59 percent to the end of 1979 and for payments of principal and interest from January 1, 1980 through December 31, 1989, at an effective annual rate of 4.5 percent and thereafter all payments to be applied to principal only. The annual payments called for were in the amount of $10,850 until 1990, and from January 1, 1990 through December 31, 1994, annual payments were to be made in the amount of $14,838, and from January 1, 1995 through December 31, 1999, annual payments were to be made in the amount of $17,064. The loan was to be paid off with an annual payment of $19,624 in the year 2000.

Arrangements comparable to the ones discussed above were made with respect to other properties acquired by Mr. Schulman in 1974 and properties acquired by him in 1975 and assigned to one of the partnerships consolidated into KIZT. In each instance the "financing" arranged by CRC was in excess of the original price of the property to Mr. Schulman and the sales price to the post office partnership was at the increased price. In each instance, the time necessary to have the property unencumbered was longer than the time required under the trust deed assumed by Mr. Schulman and the yearly sum to be paid was initially the same with a later increase.

Respondent in his notice of deficiency to each of petitioners disallowed the claimed deduction for the claimed distributive share of the partnership loss from Talmud Properties Partnership in the year 1974. The distributive loss of Talmud resulted from an interest deduction by Talmud on its partnership return of income which Talmud claimed to have paid on a loan from ABL, the proceeds of which Talmud claimed were used to make a tax-free 1-year loan to WE.

OPINION

Petitioners in this case take the position that they have shown all of the necessary elements to establish that the $1 million claimed as an interest deduction by Talmud on its partnership return of income was a proper deduction and that therefore each of the partners of Talmud properly claimed his pro rata share of the loss occasioned by that deduction. Petitioners point out that although a taxpayer bears the burden of proof with respect to a claimed deduction, after that taxpayer has established a prima facie case the burden of going forward with the evidence shifts to respondent, citing Byrum v. Commissioner, 58 T.C. 731, 735

(1972). Petitioners state that in order for an amount to be deductible as interest under section 163(a), it is necessary to show that the claimed payment was an interest payment, that it was paid or accrued in the taxable year in which it was deducted, and that the payment was made pursuant to a legally enforceable indebtedness which was the primary obligation of the taxpayer.

Petitioners state that they have established all of these elements with respect to the $1 million which Talmud claimed as an interest deduction. In support of this contention, petitioners point to the promissory notes signed by Talmud which recited that they required that interest be prepaid. They further point out that Talmud's books and canceled checks and bank statements show that the amount claimed to be deductible as interest was paid by Talmud to ABL. Petitioners rely on Stout v. Commissioner, 273 F.2d 345, 351 (4th Cir. 1959), revg. and remanding a Memorandum Opinion of this Court, for their position that these book entries and documents establish their case. Petitioners particularly rely upon the statement in that case at page 351, that--

> Book entries are not necessarily conclusive proof of the facts they represent. When made substantially contemporaneously with the events and long before any tax controversy arises, as these were, they are entitled to great weight. When the conduct of the parties is shown to be consistent with the book entries, there is no justifiable basis for findings in conflict with their disclosure. At least, a contrary finding, on this record, cannot be said to rest upon substantial evidence. [Fn. ref. omitted.]

Petitioners point to the formalities of the various transactions, namely that the notes recited the necessary elements for an enforceable promissory note and were signed by one of the partners of Talmud, and that the notes state the interest rate to be charged. Petitioners refer to the records of Talmud and its bank statements to establish that the proceeds of the indebtedness evidenced by the promissory notes were received by Talmud. They point to the form of the notes as satisfying enforceability under the laws of the State of California. They also rely on the notes to establish that the claimed indebtedness was an indebtedness of Talmud.

From their analysis of the evidence, petitioners conclude that they have established a prima facie case for the interest deduction and that it is incumbent on respondent to go forward with evidence to show that the amount is not properly deductible as interest. Petitioners then argue that respondent has not met his burden of going forward with evidence to show that the transaction was not in substance what it purported to be. They point out that suspicious circumstances may only be used as a cause to scrutinize a transaction and are not relevant in determining whether a transaction should be recognized for tax purposes. While claiming that these transactions were all at arm's length, petitioners argue that a transaction not at arm's length is merely an indication that it may be appropriate to scrutinize the transaction and does not in and of itself cause the transaction not to be one of substance.

The further argument of petitioners deals primarily with their contention that the evidence produced by the Government at most creates a suspicion which does not overcome the prima facie case established by petitioners. Petitioners contend that a taxpayer's motive is irrelevant in determining whether a transaction should be recognized for tax purposes and that a series of transactions, rather than a single transaction, is of no consequence in determining whether a transaction should be recognized for tax purposes.

Petitioners argue that there is no merit to respondent's claim that the various transactions were shams and argue that there was economic substance to the various transactions involved in this case. Petitioners point out that had Talmud offered to WE, and WE accepted, all the properties that Talmud was entitled to offer and obtained a commission on such offering of $30 million, that there was a potential for a $500,000 profit to Talmud after the $1 million interest deduction was taken. Petitioners also argue that Talmud was exposed to risks beyond its control and for this reason the transactions should be held to have substance and not be mere sham.

Respondent recognizes that the issue in this case is the deductibility by Talmud of the $1 million it claims as an interest deduction and argues that before petitioners can claim their distributive share of the losses of Talmud occasioned by this deduction, they must show that Talmud was entitled to claim this deduction and a resulting loss at a partnership level. Respondent argues that petitioners are not entitled to deduct distributive losses from Talmud because the transaction creating those losses for Talmud was a sham. In support of this argument, respondent states that Mr. Harry Margolis' office controlled all of the entities involved in the transactions in this case and that the alleged loan by ABL to Talmud did not create a bona fide indebtedness upon which an interest deduction could be claimed. Respondent further argues that the alleged loan from ABL to Talmud was a sham because there was no substance to the transaction for which the alleged loan was made. Respondent states that there is gross discrepancy between the economic benefits supposedly flowing from the purported indebtedness and the purported indebtedness itself, and for this reason the form of the transaction does not reflect its substance.

As is readily apparent, the decision in this case turns on weighing all the evidence in the record.[3] Upon an analysis of the record as a whole, we conclude that there did not in substance exist an indebtedness from Talmud to ABL and that there was no interest payment by Talmud to ABL. Not all of the documents, even on their face, support petitioners' position, although this is not the basis for our conclusion. One document that is supposedly an assignment of the notes from Talmud to ABL to Barclays Bank Tortola, without warranty, was not executed until 2 months after the notes were supposed to have been discounted to Barclays Bank Tortola to enable ABL to have funds to advance to Talmud. Also, the so-called financing agreement between Talmud and WE, which was the crux of petitioners' argument that there was some substance to the transactions, was not signed by Donald F. Cox on behalf of Talmud until 1976. However, much more important to our conclusion than these failures to comply with the form in which the transaction was purported to be established is the evidence in the record leading to the conclusion that all the transactions between Talmud, WE and ABL lacked substance.

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[3] The trial record in this case contained over 2,700 pages of transcript of testimony and over 1,000 exhibits, many of which are lengthy documents. We have not attempted in our findings to summarize all this evidence, but have stated the facts we consider relevant to the issue herein and to an understanding of our decision. We have found the facts as stipulated. Since many of the exhibits are stipulated, they are part of our findings. However, we have not recited the contents of many of these numerous exhibits in our findings.

The record shows that at least $400,000 of the purported payment by the stated partners of Talmud to the partnership was advanced to the partners by ABL and returned by the partners to ABL as an interest payment. The record does not show the source of the remaining $600,000 purportedly paid into Talmud by its partners and paid over to ABL. The record clearly shows that no $10 million was advanced by Talmud to

WE. The record shows merely a circular transfer of funds from ABL to Talmud, to WE, to Barclays Bank Tortola, back to ABL. Transfers from ABL to Talmud of amounts ranging from $500,000 to $1 million were made with the immediate transfer through bank accounts over which the law offices of Mr. Harry Margolis had control of the same amounts to WE and almost simultaneously a transfer from a bank account at Barclays Bank Tortola back to ABL. The record is not conclusive from what source the funds transferred from the Barclays Bank account at Tortola to ABL came. However, there is a reasonable inference from the record that these funds came from WE. The record shows that most funds obtained by ABL came from WE, and that the purported purchaser of the notes of ABL, Wickhams Cay Trust Co., had no substantial funds of its own and that its director had a signatory right on WE's account. There is a reasonable inference in the record that Mr. Harry Margolis could direct transfers from WE's accounts to bank accounts at Barclays Bank California. In fact, a witness for respondent, a Mrs. Vanderberg who had worked in the office of a Mr. Smeets as an employee of Curacao International Trust Co. (ABC) in the Netherlands Antilles from 1964 through 1966 and from 1968 through 1971, stated that she was aware that Mr. Margolis did direct transfers of funds to and from WE and other foreign entities. Employees of Mr. Margolis' office who handled the cash flow charts testified that it was very common to have cash flow charts prepared at the direction of Mr. Harry Margolis' office to transfer funds from a domestic entity to a foreign entity and back to the domestic entity, sometimes going through other foreign or domestic entities, in the same day. Employees of Mr. Margolis' office identified WE, Wickhams Cay Trust Co., CRC, EST, ABL and Talmud, as well as various other entities, as entities referred to in Mr. Margolis' office as "system entities." Apparently the "system entities" were ones over which Mr. Margolis had some rights to transfer funds to various bank accounts. From the evidence as a whole, we conclude that there was in fact no loan of $10 million from ABL to Talmud or the placing of $10 million by Talmud with WE, but rather merely a circular transfer of funds that originated with WE and were returned to WE, and that the purported return of the $10 million by WE to Talmud was a mere reversal of the circular transfer of funds. Certainly, there has been no reason shown for the various transfers on the same day, and the testimony in the record is that these various transfers might well be a circulation of the same funds a number of times. Although not specifically so stated, Mr. Margolis in his testimony effectively admitted that there was a circularization of funds here. He stated something to the effect that by circulating one penny often enough, he could retire the National debt.

In Karme v. Commissioner, 73 T.C. 1163, 1186 (1980), affd. 673 F.2d 1062 (9th Cir. 1982), we held that a circularization of funds such as transpired in the instant case did not in substance create an indebtedness but was effectively a sham transaction. The recent case of Goldberg v. United States, 789 F.2d 1341 (9th Cir. 1986), reaches a similar result.[4]

There are many other indications of sham in this record. If in fact Talmud had been established as a legitimate profit-making partnership, it would have required Mr. Schulman to transfer to it and give it the opportunity to finance any post office properties he acquired. However, the record shows that Talmud made no objections to the transfer of properties by Mr. Schulman to the other partnerships. This fact clearly demonstrates that Talmud was not in fact operated for a business purpose.

The record also shows that there was no reason as far as Mr. Schulman and the post office partnerships were concerned for the financing which Talmud contends it was to obtain from WE for the deposit, interest-free, of the $10 million. With respect to each of these properties, the post office partnerships would have been better off financially to have kept the financing which existed on the properties when Mr.

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[4] By letter dated July 17, 1986, petitioners' counsel directed the Court's attention to the opinion of the United States District Court, Northern District of California, in the case of United States v. Harry Margolis, No. CR-85-2086-RPA. The District Court in that case concluded with respect to a criminal action that "as a matter of law, there is nothing illegal per se about sequential circular money transfers." We have considered the opinion of the District Court, and it does not change our conclusion in this case.

Schulman acquired them by assumption of the existing deeds of trust. It is therefore clear that the reason for the refinancing did not have to do with the best interest of the post office partnerships. Furthermore, the documents signed by WE and Talmud recited an amount to be lent to Talmud on properties offered by Talmud and accepted by WE far in excess of any amounts that were actually offered. The interest-free money stated to be put up by Talmud under the agreement was to compensate for the low interest loans according to petitioners' contention. However, the record shows that each of the post office partnerships was also required to put up, according to the documents signed, interest-free funds with WE or Parallex after Parallex took over, according to petitioners' contention, the agreement of WE. There is no explanation of why this placement of funds by the post office partnerships was required. The record also lacks an explanation of why, with Talmud having the amount available from WE which the agreement stated it had, there was any reason for the formation of Koran, Isis and Zen, each of which also under a document entitled "Agreement" put up money with WE for a year, interest-free. The formation of these partnerships with Mr. Schulman a partner in each and some other Talmud partners also partners, reduced Talmud's likelihood of procuring properties to be offered for financing to WE.

The record as a whole clearly indicates that there was no substance to the formation or operation of Talmud. Forms were gone through, not always timely, to give the appearance of a business operation, but when all the facts in the record are considered, it is clear that this was merely a sham to obtain tax advantages and the avoidance of tax by clients of Mr. Harry Margolis.

Petitioners make the argument that the lack of complete bank records of all foreign transactions requires the Court to conclude that respondent has not made a sufficient showing to overcome what petitioners state is their prima facie case. The record in this case shows that the choice of petitioners was to deal with foreign entities, and respondent made many unsuccessful efforts to obtain records from the foreign entities prior to the conclusion of the trial in this case. Petitioners offered testimony from a number of witnesses to the general effect that they were unable also to obtain records from the foreign entities. Considering the relationship shown between the managers of the foreign entities and Mr. Harry Margolis, who structured the transactions here involved for petitioners, we are persuaded that personal efforts by Mr. Margolis to have obtained records from the foreign entities might have resulted in those records being forthcoming. However, it was the taxpayers' choice to deal with foreign entities, thus attempting to put beyond the reach of respondent certain documents. In our view, the absence of these documents should not require us to conclude that respondent failed in his burden of going forward with evidence by not producing these documents where, in any event, the circumstantial evidence produced by respondent is reasonably clear that the documents, if available, would support his position.[5]

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[5] Subsequent to the trial of this case and after briefs were filed, numerous documents which had been unavailable became available to counsel for respondent and counsel for petitioners. These documents were obtained in connection with other litigation. Because of the lengthy controversy over the ability of petitioners to obtain these documents and the efforts respondent made to obtain them, the Court reopened the record in this case to receive any of these foreign documents which the parties could agree were authentic. After many extensions of time, the Government filed a document attaching copies of certain records, stating that respondent and petitioners had been unable to agree to stipulate these documents. Approximately at the same time this document was filed, petitioners' counsel filed a statement that no agreement to stipulate into the record further documents would be entered into on behalf of petitioners. The Court therefore did not review or consider the documents submitted by respondent since to have received the documents, absent agreement, would have required further oral testimony. After the last extension of time for filing a stipulation, which was at petitioners' request, the Court received from respondent a report stating that counsel for respondent had been informed by counsel for petitioners that no foreign documents would be agreed to on behalf of petitioners and that petitioners did not intend to submit any of the foreign records for receipt by the Court. Having received no response from petitioners to the order of the Court allowing the parties until February 14, 1986, in which to submit foreign records, the Court on February 26, 1986, entered an order closing the trial record in this case. On May 1, 1986, counsel for petitioners filed a document entitled "Motion to Reopen Record" in which the background of the foreign records becoming available was recited and in which petitioners represented that they did not have the wherewithall to review the foreign documents nor were they certain that all documents could be located which would be relevant to the case because the years to which the relevant documents related were 1974 and 1975. Petitioners requested

(footnote continued)

Based on the record as a whole, we conclude that Talmud did not borrow $10 million from ABL, did not in substance make an interest payment of $1 million to ABL and did not place $10 million interest-free with WE, but that all of the forms of papers signed purporting to show such transactions were shams executed solely for the purpose of obtaining tax deductions for petitioners.

This case is before the Court on the severed issue of whether each petitioner is entitled to deduct his pro rata share of losses reported by Talmud on its partnership return of income for the year 1974. We have decided this issue for

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(footnote continued from previous page) that the record be reopened for petitioners to introduce testimonial evidence to explain and clarify the documents respondent had offered to the Court which had not been received by the Court in evidence and "that the record be reopened for the taking of testimonial evidence from witnesses by respondent." This motion was denied. From certain statements contained therein, particularly the statement suggesting that petitioners did not intend to review the records or to offer in evidence any of the documents which were now available, it appeared that any further hearing would serve no useful purpose. None of the documents submitted by respondent have been reviewed or considered by the Court and the Court's conclusion in this case is based on the trial record as made and the fair inferences to be drawn therefrom. However, again the Court emphasizes that when taxpayers deal with foreign entities, attempting to make documentation of their transactions unavailable to respondent, the argument that respondent has failed to produce documents conclusive as to certain facts as distinguished from evidence giving a clear inference that those facts are true, does not, as petitioners contend, warrant a holding for petitioners.

respondent. Since it is not clear from the record whether other issues will require these cases to be further litigated,

Decisions will be entered under Rule 155 in those cases which have no other pending issues, and any other cases will be restored to the general docket.

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9.

UNITED STATES TAX COURT

GEORGE S. NEUMAN and GLORIA NEUMAN, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 39514-85. Filed July 30, 1986.

Jan S. Neiman, for the petitioners.

William V. Spatz, for the respondent.

MEMORANDUM OPINION

PARR, Judge: This case is before the Court on respondent's Motion to Dismiss for Lack of Jurisdiction, filed on December 19, 1985. The issue is whether petitioners timely filed their

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petition with this Court as required by section 6213[1] and Rule 13(c). A hearing on the motion was held in Miami, Florida on April 28, 1986. At the conclusion of the hearing, the Court took the motion under advisement.

By notice of deficiency dated July 2, 1985, respondent determined the following deficiencies in and additions to petitioners' Federal income taxes:

		Additions to Tax	
Year	Deficiency	Sec. 6659	Sec. 6661
1980	$ 44,241.46	-	-
1981	104,683.00	$24,814.00	-
1982	101,458.00	23,655.00	$3,751.00

The notice of deficiency was mailed by certified mail to petitioners' last known address pursuant to section 6212, at 1500 Northwest 203rd Street, Miami, Fla. 33169.

Under section 6213(a)[2] and Rule 13(c), a petition for redetermination of a deficiency must be filed with this Court within 90 days after the notice of deficiency is mailed to a taxpayer. If the petition is not filed within the prescribed time, it must be dismissed for lack of jurisdiction. Estate of Rosenberg v. Commissioner, 73 T.C. 1014 (1980); Estate of Cerrito v. Commissioner, 73 T.C. 896 (1980).

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[1] All section references are to the Internal Revenue Code of 1954, as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Section 6213(a), which permits the filing of petitions with this Court, provides in part:

> Within 90 days * * * after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. * * *

The 90th day after the mailing of the notice of deficiency was Monday, September 30, 1985, which date was not a legal holiday in the District of Columbia. The petition herein was dated September 27, 1985, within the 90-day period. The envelope in which the petition was mailed was properly addressed, postage prepaid, and bears a private postage meter stamp date of September 27, 1985. The petition was received by the Court on October 28, 1985, the 118th day, and filed on that date.

In order to be timely filed under section 6213(a), a petition must be received by the Tax Court in Washington, D.C., on or before the 90th day. The petition is thus deemed filed on the date of receipt. However, section 7502(a) provides that if the envelope or wrapper containing the petition is delivered by United States mail after the expiration of the 90-day period, but contains a United States postmark bearing a date which falls within the 90-day period, the date of that postmark is deemed to be the date of delivery. In that situation, the petition is deemed filed when postmarked.

Under section 7502(a), then, if the petition in this case had contained a United States postmark date of September 27, 1985, the petition would have been timely filed no matter when received at the Court. It is the date of the United States postmark, not the date on which an envelope is actually placed in a United States mailbox, which is the date of filing under section 7502(a). Estate of Moffat v. Commissioner, 46 T.C. 499, 501 (1966).

Where an envelope bears a private metered mail stamp, as in this case, section 7502(b) applies. That section provides that the Secretary of the Treasury may prescribe regulations regarding the extent to which section 7502 shall apply to postmarks not made by the U.S. Postal Service.

Section 301.7502-1(c)(1)(iii)(b),[3] Proced. & Admin. Regs., sets forth the conditions under which section 7502 applies to privately metered mail. Under the regulation, if petitioners' envelope, which contains a private postmark bearing a date within the 90-day filing period, was received no later than the ordinary delivery time for mail postmarked at the same place of origin by the United States Postal Service, the petition will be considered timely filed. However, if that envelope was received later than the ordinary delivery time for documents so mailed and so postmarked by the United States Postal Service, it will be considered timely only if petitioners can prove three things: (1) that the envelope was actually deposited in the mail before the last pick-up from that mailbox on September 30, 1985; (2) that the delay in receiving the petition was due to a delay in the transmission of the mail; and (3) the cause of delay.

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[3] In pertinent part, sec. 301.7502-1(c)(1)(iii)(b), Proced. & Admin. Regs., reads as follows:

> (b) If the postmark on the envelope or wrapper is made other than by the United States Post Office, (1) the postmark so made must bear a date on or before the last date, or the last day of the period, prescribed for filing the document, and (2) the document must be received by the agency, officer, or office with which it is required to be filed not later than the time when a document contained in an envelope or other appropriate wrapper which is properly addressed and mailed and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the United States Post Office on the last date, or the last day of the period, prescribed for filing the document. However, in case the document is received after the time when a document so mailed and so postmarked by the United States Post Office would ordinarily be received, such document will be treated as having been received at the time when a document so mailed and so postmarked would ordinarily be received, if the person who is required to file the document establishes (i) that it was actually deposited in the mail before the last collection of the mail from the place of deposit which was postmarked (except for the metered mail) by the United States Post Office on or before the last date, or the last day of the period, prescribed for filing the document, (ii) that the delay in receiving the document was due to a delay in the transmission of the mail, and (iii) the cause of such delay. * * *

At the outset, we note that this regulation has been held to be valid. See Lindemood v. Commissioner, 566 F.2d 646, 649 (9th Cir. 1977), affg. a Memorandum Opinion of this Court; Fishman v. Commissioner, 51 T.C. 869, 872-873 (1969), affd. per curiam 420 F.2d 491 (2d Cir. 1970).

Whether a petition is received at the Tax Court in the ordinary delivery time is a factual question. Stotter v. Commissioner, 69 T.C. 896 (1978); Leventis v. Commissioner, 49 T.C. 353 (1968).

At the hearing on this motion, respondent introduced evidence that a piece of mail dropped in United States Postal Service depositories in Miami, Fla., on September 27, 1985, should have been received by the Tax Court in Washington, D.C. in about six days. James T. Doran, Quality Control Manager at the United States Postal Service General Mail Facility in Miami, Fla., testified for respondent on this point, and described the various tests monitored by his unit to measure delivery time. According to Mr. Doran, of the mail dropped in mailboxes in Miami on September 27, 1985, 13 percent was received in Washington, D.C. by September 28, 1985; 70 percent by September 30, 1985; 82 percent by October 1, 1985; 89 percent by October 2, 1985; and 100 percent by October 3, 1985.

On cross-examination by petitioners' counsel, Mr. Doran admitted that occasionally a letter might get lost, and that there is a degree of error in the testing. We are satisfied, however, that the normal delivery time for a letter mailed on September 27, 1985 from Miami to Washington, D.C. would be about 5 or 6 days. In any event, there is no evidence that the normal delivery time would be 31 days, as petitioners apparently would have us believe. We therefore find that the petition herein was delivered after the time when a document so mailed and so postmarked would have ordinarily been received.[4]

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[4] In other cases, we have declined jurisdiction and held that the mailing period was not ordinary when far shorter time periods were involved. See Rickard v. Commissioner, T.C. Memo. 1986-31 (13-day mailing period from Daytona Beach, Fla.); Estate of Labovitz v. Commissioner, T.C. Memo. 1985-538 (8-day mailing period from Blue Bell, Pa.); Estate of Reiners v. Commissioner, T.C. Memo. 1981-275 (8-day mailing period from Morris, Minn.); Berry v. Commissioner, T.C. Memo. 1981-106 (7-day mailing period from Augusta, Ga.); Estate of Levison v. Commissioner, T.C. Memo. 1979-470 (8-day mailing period from New York, N.Y.).

Since petitioners' envelope was not received within the ordinary time for delivery, they must establish that it was actually mailed on or before September 30, 1985, that the delay in receipt was caused by the mails, and the cause of the delay. The burden of proof as to these facts is on the petitioners. Fishman v. Commissioner, 51 T.C. at 873; Rule 142.

Petitioners attempted to show that the petition was actually mailed on September 27, 1985, through the testimony of their Certified Public Accountant, Mr. Infeld, and his secretary, Ms. Stead. Mr. Infeld stated that on Friday, September 27, 1985, he had instructed Ms. Stead to mail the petition, telling her that it had to go out that weekend. Ms. Stead testified that she had mailed it that day by taking it to the post office and dropping it in the slot marked "metered mail". This testimony is clearly self-serving in nature, and is insufficient to convince us that the petition was actually mailed on September 27, 1985.

Both Mr. Infeld and Ms. Stead also testified as to a "mailing log" maintained by their office. Although the original of this log book was not brought to the hearing, a copy of the appropriate pages was attached to petitioners' response to this motion to dismiss. The words "U.S. Tax Court - GSN" appear under the date 9-27-85 at the bottom of a column of other entries. This entry appears as if it may have been made at a later time, as the spacing between it and the next date seems cramped and irregular when compared with other entries on the log.

Petitioners further attempted to prove that the petition was mailed on September 27, 1985, by citing a section of the Domestic Mail Manual which requires privately metered mail to be postmarked by the U.S. Postal Service if the mailing date is other than that shown on the wrapper. The existence of this manual section (a copy of which is not in evidence) does not alone convince us that such postmarking is normal practice or that the absence of such postmarking is prima facie evidence that the private meter stamp was correct. In fact, the only testimony offered in relation to this manual provision was that of Mr. Doran. He stated that he was not aware of any such requirement and that compliance with it would be almost an impossibility.[5]

In any event, even if we accept petitioners' assertion that the petition was mailed on September 27, 1985, petitioners have not met their burden of establishing that the delay in receipt was caused by the transmission of the mails, or the cause of the delay. We therefore hold that the requirements of section 301.7502-1(c)(1)(iii)(b), Proced. & Admin. Regs., have not been met. Since the petition will not be considered timely filed, we must grant respondent's motion to dismiss for lack of jurisdiction.

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[5] The manual section petitioners refer to appears to be the successor of the postal regulation relied on by the taxpayers in Fishman v. Commissioner, 51 T.C. 869 (1969), affd. per curiam 420 F.2d 491 (2d Cir. 1970). That regulation required corrective postmarking by the U.S. Postal Service of wrongly dated metered mail. In Fishman we rejected the taxpayers' argument that the fact that the post office did not change the metered mail postmark was proof that the petition was timely mailed. We stated: "With respect to the postal regulations, the evidence indicates that it is impossible for the Post Office to check every piece of metered mail and correct every erroneous date." 51 T.C. at 873. See also Valletta v. Commissioner, T.C. Memo. 1970-232.

We recognize that the result in this case is harsh.[6] However, as the Ninth Circuit stated in Lindemood v. Commissioner, supra, the regulation "leaves no room for exceptions or judicial interpretation." 566 F.2d at 649. Taxpayers must comply with every requirement of the regulation, or else we are compelled, as here, to dismiss for lack of jurisdiction.[7]

An appropriate order of dismissal will be entered.

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[6] We also recognize, however, that a private postage meter carries with it the potential for abuse by the user, who could apply any postmark he or she needs to establish proper mailing. See Lindemood v. Commissioner, 566 F.2d 646, 649 (9th Cir. 1977), affg. a Memorandum Opinion of this Court; Wiese v. Commissioner, 70 T.C. 712, 714 (1978); Rickard v. Commissioner, supra.

[7] Petitioners are of course free to contest respondent's determination after they pay the deficiencies and additions to tax, by filing a claim for refund, and, if necessary, suing to recover the amounts in the United States Claims Court or appropriate district court. See Drake v. Commissioner, 554 F.2d 736 (5th Cir. 1977).

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T. C. Memo. 1986-330

UNITED STATES TAX COURT

BENJAMIN W. DAJOS, JR., Petitioner v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 35713-84. Filed July 30, 1986.

Jeffrey B. Levine, for the petitioner.

Pamela R. Martin, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge: In his notice of deficiency, respondent determined additions to tax in petitioner's 1969 through 1974 Federal income tax liabilities, as follows:

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Year	Addition to Tax, I.R.C. 1954 Section 6653(b)[1]
1969	$ 5,992.72
1970	25,279.50
1971	7,324.15
1972	7,889.15
1973	20,196.86
1974	33,065.22

The sole issue for decision is whether any part of petitioner's underpayment of tax for the years 1969 through 1974 is due to fraud.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and related exhibits are incorporated herein by this reference.

At the time of filing the petition in this case, petitioner resided in Coldwater, Mich.

Petitioner is an attorney who received his law degree from the University of Michigan in 1955 and is admitted to practice law in the State of Michigan.

During the years 1969 through 1974, petitioner was a self-employed attorney in Coldwater, Mich. Petitioner established his practice in 1957. His practice was a general practice including criminal, personal injury, divorce and other matters. Petitioner handled no tax cases, nor did he engage in tax return preparation for any of his clients. His only connection with tax matters was in divorce cases, where he would advise his clients to stipulate which parent would be entitled to dependency exemptions for the children.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue.

Petitioner began his law practice as a solo practitioner. However, during the tax years at issue his practice had grown and he employed other attorneys.

From the time he opened his law practice, and throughout the years at issue, petitioner employed no bookkeeper or accountant. Petitioner devised and established the bookkeeping and accounting system for his office. Petitioner had no formal training in accounting matters.

The bookkeeping system petitioner set up worked as follows: When a client retained petitioner on a matter, and paid a fee, petitioner or his secretary would prepare a receipt for the amount. A carbon copy of the receipt would remain on a "receipt sheet" or "board." Approximately 30 receipts would fill such a sheet, at which point petitioner or his secretary would deposit the money in a "trust" or "escrow" account (petitioner's terminology) maintained by petitioner at the Branch County Bank ("Branch County account"). This bank was one of two banks in existence in Coldwater, Mich., when petitioner's practice began in 1957. Expenses incurred in connection with a client matter would be paid out of this account.

A separate ledger sheet was set up for each of petitioner's cases. The fee received for handling a case would be recorded on the ledger sheet. Any expenses paid out of the Branch County account in relation to a case would also be noted on the appropriate ledger sheet. The ledger sheet for each case also contained other notations for meetings, trial dates, etc.

A second bank account was maintained by petitioner at the Southern Michigan National Bank, the other bank in Coldwater ("Southern Michigan account"). This account was used to pay petitioner's operating expenses, such as telephone, rent and supplies.

Whenever the Southern Michigan account was overdrawn, or petitioner became aware he needed additional funds in that account to meet operating expenses, he would transfer money from the Branch County account into the Southern Michigan account. Petitioner or his secretary would first look through the ledger cards maintained for each case. If the work on a case had been completed, the case could be closed. The expenses charged to that case, which had been recorded on the card, would be subtracted from the fees received. Any excess would be considered by petitioner to be income to the practice, and could then be transferred over to the Southern Michigan account to use in paying the firm's expenses. Usually, 20 or 30 cases would be closed, and the applicable amounts transferred, at a given time.

Petitioner had sole signatory authority over the two bank accounts. As the practice was run as a sole proprietorship, the name on the accounts was petitioner's alone. Petitioner rarely handled the actual banking or bookkeeping, however. His secretary almost always took care of the receipt of fees and payment of expenses, and maintained the books and records of the practice. She would endorse checks and transfer funds on his behalf, using his stamp.

From time to time, when the funds in the Branch County account exceeded the limits protected by Federal insurance, petitioner would withdraw the excess funds and use them to purchase certificates of deposit. Petitioner would make personal use of the interest earned on the certificates. When a certificate matured, petitioner or his secretary would prepare a new receipt for the amount of principal and redeposit the funds into the Branch County account.

Other than the interest on the certificates of deposit, petitioner did not pay himself any salary or take a regular draw during the years at issue. Petitioner did not maintain an extravagant or high standard of living. His personal living expenses were minimal. He was single and, at least in the early years, lived with his parents while he worked to establish his practice. He rarely bought clothes, ate in restaurants, or took vacations, except for attending the annual American Bar Association convention. Petitioner did own a car and spent money for related expenses, such as gasoline and insurance.

Petitioner was a hard-working, conscientious attorney. At all times he attempted to segregate what he considered to be his clients' funds, in the Branch County account, from those used to run his law office, in the Southern Michigan account. He set up his bookkeeping system, without professional advice, with the intent of accurately recording his firm's fees and expenses. Once his bookkeeping system was established, petitioner and his employees, which after a while included other attorneys, followed it consistently. The system was established in 1957 and was used during the years at issue.

As a result of petitioner's home-made accounting methods, petitioner concluded at the end of each year that his practice had no taxable income. All income from a client's case, once closed, would be transferred into the Southern Michigan account, where it would be used to pay operating expenses. Since the balance in that account was always being depleted, requiring new transfers of money from the Branch County account, petitioner would arrive at the erroneous conclusion that the firm had no net income. Petitioner therefore did not file any income tax returns from 1957 through 1974.

On April 9, 1979, petitioner was charged by information with three counts of willful failure to file an income tax return for the years 1972, 1973 and 1974, in violation of 26 U.S.C. section 7203. Petitioner pled guilty to count two of the information, the charge relating to 1973, on June 13, 1979.

During the Internal Revenue Service investigation of petitioner's failure to file, petitioner cooperated fully with the investigating agents. Petitioner answered all questions, and provided the agents with all requested books and records, cancelled checks, and bank statements.[2] He permitted the agents to examine the records on the premises as well as to remove them from the premises. On several occasions petitioner reiterated that he thought his accounting system was right, and asked them to correct him if it was wrong. His records were complete enough for respondent to easily and accurately determine taxable income.

Petitioner earned gross receipts in years 1969 through 1974 as follows:

Year	Gross Receipts
1969	$ 58,892.96
1970	118,464.88
1971	71,826.79
1972	86,134.46
1973	129,636.37
1974	162,084.96

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[2] The extent of petitioner's cooperation with respondent's investigation is illustrated by this excerpt from petitioner's testimony at trial:

> * * * they wanted to see our cancelled checks, and we showed them the cancelled checks from the Branch County Bank. We showed them all of our cancelled [checks] from the Southern Michigan Bank. We showed them our checkbook. All of our checkstubs. We showed them all of our receipt sheets. And anything they asked for we gave to them. And there was a time when obviously it would take time to look through these things, and particularly when Mr. Blackburn [the special agent] was there, they would go to our library and they could use, you know, I made the library available to them. They could look at records all they wanted to. We took them coffee. I mean I did everything I could to try to accomodate them because I had the impression that they were just sort of checking up to see whether my system was correct or not. [Transcript pp. 18-19.]

Petitioner earned interest income in 1969 through 1974 as follows:

Year	Interest Income
1969	$ 1,124.98
1970	2,525.89
1971	5,038.73
1972	8,137.50
1973	10,934.20
1974	16,133.06

During the years 1969 through 1974, petitioner had taxable income as follows:

Year	Taxable Income
1969	$ 28,597.00
1970	90,306.00
1971	39,518.00
1972	41,580.00
1973	86,815.00
1974	114,695.00

Petitioner was liable for underpayments in income tax resulting from the receipt of undeclared taxable income for the years 1969 through 1974, as follows:

Year	Underpayment in Income Tax
1969	$11,985.45
1970	50,559.00
1971	14,648.29
1972	15,778.31
1973	40,393.72
1974	66,130.00

Petitioner has paid in full all taxes and interest owing for the years 1969 through 1974.

OPINION

Section 6653(b) provides for an addition to tax equal to 50 percent of the underpayment of tax, if any part of the underpayment is due to fraud. Respondent has the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b);[3] Zack v. Commissioner, 692 F.2d 28 (6th Cir. 1982), cert. denied 460 U.S. 1084 (1983), affg. a Memorandum Opinion of this Court. Respondent must establish that there was an underpayment of tax, and that part of that underpayment was due to the taxpayer's fraud. Hebrank v. Commissioner, 81 T.C. 640 (1983). For purposes of this section, fraud is an actual, intentional wrongdoing. Mitchell v. Commissioner, 118 F.2d 308 (5th Cir. 1941). The intent required is the specific purpose to evade a tax believed to be owing. Stoltzfus v. United States, 398 F.2d 1002 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Professional Services v. Commissioner, 79 T.C. 888 (1982). Whether fraud exists is a question of fact to be determined from the entire record. Rowlee v. Commissioner, 80 T.C. 1111 (1983); Gajewski v. Commissioner, 67 T.C. 181 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978).

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[3] All Rule references are to the Tax Court Rules of Practice and Procedure.

Fraud is never presumed, but rather must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85 (1970). Circumstantial evidence is permitted where direct evidence of fraud is not available, and fraud may be properly inferred where a taxpayer's entire course of conduct establishes the necessary intent. Stephenson v. Commissioner, 79 T.C. 995 (1982), affd. per curiam 748 F.2d 331 (6th Cir. 1984); Rowlee v. Commissioner, supra; Stone v. Commissioner, 56 T.C. 213 (1971). Fraud may not, however, be inferred from a mere understatement of income, Holland v. United States, 348 U.S. 121 (1954), or from a deficiency in taxes due to an honest mistake or poor judgment. Iley v. Commissioner, 19 T.C. 631 (1952).

In the circumstances of this case, we conclude that respondent has not met his burden of establishing fraud by clear and convincing evidence. Although it is undisputed that petitioner failed to file income tax returns during the years at issue, the mere failure to file a return, standing alone, is not sufficient to establish fraud. Kotmair v. Commissioner, 86 T.C. ____ (June 19, 1986). There must also be some other proof of fraudulent intent to evade tax, through other indicia or "badges" of fraud. Solomon v. Commissioner, 732 F.2d 1459 (6th Cir. 1984), affg. a Memorandum Opinion of this Court.

No other indicia of fraud are present in this case. Certainly, no direct evidence of fraud has been adduced. There is no evidence of any falsification or alteration of books and records. Petitioner and his office staff consistently maintained and preserved careful records. There is also no evidence of concealment or attempts to mislead respondent's agents. Petitioner was cooperative and forthright throughout respondent's investigation and the trial of this case, answering questions directly and candidly and supplying all requested books and records. At trial, he impressed us as a sincere (though mistaken) individual, and did not appear to be evasive or deceptive in any way. Petitioner's actions and statements do not demonstrate an intent to evade a tax he believed to be owing.

Nor do we find any circumstantial evidence, gleaned from petitioner's entire course of conduct, which compels the conclusion that petitioner fraudulently intended to evade taxes. Respondent bases his arguments in support of a finding of fraud mainly on the fact that petitioner was an attorney whose practice earned substantial gross receipts during the years at issue and who personally devised and supervised the accounting system maintained in his office.[4] While such facts are not disputed, we do not find them, standing alone, sufficient to establish fraudulent intent in this case.

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[4] Respondent also urges us to consider petitioner's long history of failing to file returns and failure to report substantial amounts of income as evidence of fraud. Clearly, such a pattern may be considered in determining whether fraud exists. See, e.g., Powell v. Granquist, 252 F.2d 56 (9th Cir. 1958); Kurnick v. Commissioner, 232 F.2d 678 (6th Cir. 1956), affg. a Memorandum Opinion of this Court. We do not, however, believe it to be conclusive evidence. In Powell v. Granquist, supra, the taxpayer did not cooperate completely with the investigating agents. This factor and others led to the court's finding of fraudulent intent--factors not present here. Moreover, in the instant case, petitioner's history of nonfiling is consistent with his testimony that his method of bookkeeping led him to believe he had no taxable income, year after year. Petitioner's consistent pattern of failure to file does not, therefore, convince us that such failure was due to fraud.

We have not overlooked the fact that petitioner is an attorney. In determining the presence or absence of fraud, we "must consider the native equipment and the training and experience of the party charged." Iley v. Commissioner, 19 T.C. at 635. However, even in cases involving attorneys with knowledge of tax law, or Certified Public Accountants, this Court has always required some indicia of fraud other than the mere failure to file returns in order to support a finding of fraud.

For instance, in Rinehart v. Commissioner, T.C. Memo. 1983-184, we held that respondent had not met its burden of proving fraud although the taxpayer, who had omitted income, overstated deductions, and previously pled guilty to the crime of willfully filing a false return under section 7206(1), was an experienced attorney with a great familiarity with tax law.

In Solomon v. Commissioner, T.C. Memo. 1982-603, affd. per curiam 732 F.2d 1459 (6th Cir. 1984), the taxpayer was a Certified Public Accountant who failed to file for several years in which he earned substantial amounts of income, including embezzlement income. While we held that he was liable for the addition to tax for fraud, we applied the same standard as in any other fraud case, and based our holding not on the taxpayer's education alone, but also on proof of concealment, destruction of records, and other badges of fraud.

In Beaver v. Commissioner, supra, the taxpayer was a C.P.A. who did not file a return for seven years, until after the Internal Revenue Service discovered his delinquency. Our finding that he had fraudulently intended to evade tax was based on evidence of concealment and attempts to mislead respondent's agents, and not on the taxpayer's knowledge of tax law alone. We likewise found fraud in Estate of Ming v. Commissioner, T.C. Memo. 1976-115, a similar case involving an attorney with knowledge of tax law who had failed to file returns and attempted to deceive the Internal Revenue Service representative investigating the matter.

Finally, in Koeneman v. Commissioner, T.C. Memo. 1958-186, we held that an attorney with experience in tax law was liable only for the addition to tax for failure to file returns, and not for fraud, where he had failed to file for several years but had fully cooperated during his investigation and had not attempted to falsify records, mislead the government or conceal income. In that case we stated that "[t]o sustain [the Commissioner] on the record with respect to this issue, would require us to hold that the bare failure of an attorney possessing some knowledge of the requirements of Federal tax law to file returns, amounts to fraud with intent to evade tax on the part of such an attorney. This we are unwilling to do." Koeneman v. Commissioner, supra (17 T.C.M. 936, 939, 27 P-H Memo T.C. par. 58,186 at 810-58).

We admit that it is difficult to imagine how a licensed attorney, with nearly 20 years of experience, a graduate of a recognized law school, could have so misconstrued his financial situation or so neglected his legal obligations. After examining the record, however, we conclude that petitioner lacked the specific intent to evade tax which is required to find fraud.

We agree with respondent insofar as he argues that given petitioner's education and professional background, petitioner should have better understood his obligation to file returns and pay tax. If the additions to tax at issue herein were pursuant to section 6651(a), failure to file, or section 6653(a), negligence, we would have reached a different result. Petitioner's failure to file was clearly willful and his underpayment of tax negligent within the meaning of those sections.[5] In particular, we note that petitioner's personal use of the interest earned on the certificates of deposit must have, or at least should have, indicated to him that he had taxable income other than money which was constantly being funneled back into the practice. Even assuming that petitioner knew, from the interest income, that he should have filed a return but failed to do so, we do not find fraud as defined by the authorities cited herein. The evidence in this case nowhere reaches the level of proving a specific purpose to evade tax. At most, what has been proved is a negligent, misguided method of accounting and a willful failure to file as a result of such method.

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[5] Moreover, petitioner would be collaterally estopped from denying that his failure to file in 1973 was both willful and due to negligence based on his criminal conviction under sec. 7203 as to that year. See Kotmair v. Commissioner, 86 T.C. ___ (June 19, 1986); Castillo v. Commissioner, 84 T.C. 405 (1985). The fact that petitioner's conviction was based on a guilty plea has no bearing on the collateral estoppel effect of that conviction. Arctic Ice Cream Co. v. Commissioner, 43 T.C. 68 (1964). The sec. 7203 conviction does not collaterally estop petitioner from denying that his underpayment for 1973 was due to fraud, however. Miller v. Commissioner, 1986-280.

We note that respondent chose not to assert, in the alternative, the additions to tax for negligence or failure to file, but rested his case entirely on proving fraud. On brief, however, respondent invited the Court to assert the above additions to tax as alternatives on our own initiative, in the event that we do not find fraud. We decline to do so. Again, had respondent himself asserted these additions to tax in his notice of deficiency, in an answer, or in a motion to conform the pleading to the proof at close of trial, we would have considered the issue and sustained his determination in this regard. However, it is too late on brief to raise a new issue which petitioner had no chance to argue. As respondent's entire case was therefore based on the issue of fraud, and we have found for petitioner on this issue,

Decision will be

entered for petitioner.

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T. C. Memo. 1986-331

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UNITED STATES TAX COURT

DENNIS HOWARD JOHNSON, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 32691-85. Filed July 30, 1986.

Dennis Howard Johnson, pro se.

Elise Alsair, for the respondent.

MEMORANDUM OPINION

PANUTHOS, Special Trial Judge: This case was heard pursuant to the provisions of section 7456(d) of the Internal Revenue Code of 1954 and Rules 180, 181 and 182.[1]

Respondent determined a deficiency in petitioner's Federal income tax for the taxable year 1982 in the amount of $189.

The issues for decision are: (1) whether petitioner omitted $1,457 from his jointly filed Federal income tax return, and (2) whether, if petitioner omitted income, he qualifies as an innocent spouse within the meaning of section 6013(e).

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

ORIGINAL

C. M.

At the time of filing the petition herein petitioner resided at Cheshire, Connecticut.

During 1982 petitioner was married to Joanne M. Johnson (hereinafter Joanne). Sometime after 1982 petitioner separated from his wife and was divorced. Petitioner and Joanne filed a joint Federal income tax return reporting wages of $8,611.55.

In his notice of deficiency, respondent determined that Joanne received $1,457 in taxable income from Racquetball Plus, Inc., which amount was not reported on the jointly filed return. Petitioner was aware that Joanne worked for Racquetball Plus, Inc., but did not known the amount of earnings.

The adjustments in the notice of deficiency are presumptively correct and the burden of proof is on petitioner to establish error. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Since petitioner failed to present any evidence to establish error, respondent's determination is sustained with respect to the omitted income.

Petitioner argues that he qualifies as an innocent spouse under section 6013(e). In order for petitioner to qualify for relief the following conditions must be satisfied:

> (e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.-
>
> (1) IN GENERAL.-Under regulations prescribed by the Secretary, if
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
>
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatment.

Petitioner has the burden of proving that all requirements for innocent spouse relief are satisfed. Ratana v. Commissioner, 662 F.2d 220, 224 (4th Cir. 1981); Sonnenborn v. Commissioner, 57 T.C. 373, 380-381 (1971).

The parties agree that petitioner filed a joint return for the year in issue and, accordingly, the first requirement is satisfied. We discussed the second requirement in Walker v. Commissioner, T.C. Memo 1985-278 as follows:

> The second requirement is that there be a substantial understatement of tax attributable to grossly erroneous items of one spouse. "Grossly erroneous items" in section 6013(e)(1)(B) includes any item of gross income attributable to such spouse which is omitted from gross income. Sec. 6013(e)(2)(A). "Substantial understatement" in section 6013(e)(1)(B), (C), and (D) means any understatement of tax (as defined in section 6661(b)(2)(A)) which exceeds $500. Sec. 6013(e)(3).***[2]

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[2] See Walker v. Commissioner, T.C. Memo. 1985-278.

Respondent argues that there is not a substantial understatement of tax since the tax on the omitted income is $189. Sections 6013(e)(3) and 6661(b)(2)(A).[3] Petitioner argues that the amount to be considered for purposes of a substantial understatement is $1,457 (the omitted income) rather than $189 (the tax on the omitted income).

We agree with respondent. Section 6013(e)(1)(B) is clear. It refers to the word "tax" and not "income". Furthermore, sec. 6661(b)(2)(A) defines understatement as "the excess of the amount of tax [emphasis added] required to be shown on the return*** over the amount of tax [emphasis added] imposed which is shown on the return." Thus there is no doubt that the deficiency of $189 does not qualify as a substantial understatement. Based on the foregoing, petitioner does not qualify under section 6013(e)(1)(B). Further, since all four statutory requirements must be satisfied, and petitioner has failed to satisfy the second requirement we need not consider sections 6013(e)(1)(C) and (D). Estate of Jackson v. Commissioner, 72 T.C. 356, 360 (1979).[4]

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[3] Since the liability is attributable to the omission of an item of gross income the provision requiring that the understatement must exceed a specified percentage of the spouse's income does not apply. Section 6013(e)(4)(E).

[4] See also Walker v. Commissioner, supra.

As a final matter petitioner seeks equitable relief from this Court. While section 6013(e) is remedial in nature,[5] we do not have equity power to avoid the clear language of a statute. Commissioner v. Gooch Co., 320 U.S. 418, 422 (1943)

Decision will be entered

for the respondent.

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[5] See Walker v. Commissioner, supra.

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T. C. Memo. 1986-332

UNITED STATES TAX COURT

JOHN GERARD FINN AND BELINDA JO FINN, Petitioners *v*. COMMISSIONER OF INTERNAL REVENUE, Respondent

ANNA V. FINN, Petitioner *v*. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 12940-84, 14596-84. Filed July 31, 1986.

H and W were divorced in 1977. In 1981, both claimed dependency deductions for their two children, who were in the custody of W. In that year, H furnished over $1,200 in support of each child. *Held*, W failed to prove that she provided more support for the children than did H; therefore H, not W, is entitled to claim the dependency deductions. Sec. 152(e)(2)(B), I.R.C. 1954.

John Gerard Finn and Belinda Jo Finn, pro se in docket No. 12940-84.

Anna V. Finn, pro se in docket No. 14596-84.

Frank E. McDaniel, for the respondent.

ORIGINAL

G.M

MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, Chief Judge: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

Docket No.	Petitioner	Tax Year Ended December 31,	Deficiency	Date of Notice
12940-84	John Gerard Finn and Belinda Jo Finn[1]	1981	$511	2/15/84
14596-84	Anna V. Finn	1981	419	2/15/84

The sole issue before the Court is whether the custodial or noncustodial parent is entitled to the dependency deductions for their two children.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

Petitioner Anna V. Finn (hereinafter Anna) resided in Stone Mountain, Georgia and petitioner John Gerard Finn (hereinafter John) resided at Robins Air Force Base, Georgia at the time they filed their petitions in this case. Anna filed her Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center in Chamblee, Georgia and John and his wife, Belinda Jo Finn, filed their joint Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center in Philadelphia, Pennsylvania.

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[1] Belinda Jo Finn is a petitioner in this case solely because she was married to petitioner John Gerard Finn during the year in issue and filed a joint return with him for that year.

John and Anna were married in December 1971 and they subsequently were divorced on May 18, 1977. Two children were born of this marriage. Their daughter, Erin, was born in June 1974 and their son, Devin, was born in November 1975. Pursuant to the divorce decree, and at all relevant times, Anna had custody of the children and John had visitation rights.

During the taxable year in issue, John made payments to Anna totaling $2,075 per child for child support. In addition, the children visited John a total of 75 days and he incurred the following expenditures with respect to the children:

	Erin	Devin
Food	$243.06	$243.06
Vacation	42.24	42.24
Gifts	120.49	82.80
Clothes	23.00	13.00
Haircuts	9.50	9.50
Miscellaneous	57.59	47.98
Total[2]	$495.88	$438.58

During 1981, Anna and the children resided at Kristian Court in Stone Mountain. The residence was purchased by Anna with governmental assistance in 1980. In 1981, pursuant to the assistance plan, Anna made payments on the principal of the mortgage totaling $2,947.81 and the government made interest payments on the mortgage totaling $2,756.39.

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[2] The total support furnished by John for Erin was $2,570.88 ($2,075.00 + $495.88) and the total support furnished by John for Devin was $2,513.58 ($2,075.00 + $438.58). John also spent, inter alia, $934.08 for airline tickets that were purchased to enable Erin and Devin to visit him during 1981. This expenditure does not constitute an item of support. Hopkins v. Commissioner, 55 T.C. 538, 541-542 (1970).

The Kristian Court residence has three bedrooms, one bathroom, a basement, a small living room, a combined kitchen and dining area, and a one-car garage. During 1981, the fair rental value of the home was $560 per month, of which $271[3] constitutes support provided by a government agency. In addition, Anna paid utility expenses for the residence totaling $1,178.52 and incurred and paid minor repair and replacement expenses for the residence totaling $411.46. Thus, the total amount relating to the residence, excluding governmental assistance, was $5,057.98.[4] Twenty percent of this amount, $1,011.60, represents the portion of Anna's cost in providing shelter that is allocable to each child. See pages 8-9, *infra*.

The total support furnished by Anna for her children during 1981 was as follows:

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[3] The amount of support provided by the governmental agency was calculated as follows:

$$\text{monthly fair rental value of the home} \times \frac{\text{house payments made by the government}}{\text{total house payments made by the government and Anna}}$$

$560 x $2,756.39/$5,704.20 = $271 (rounded to the nearest dollar)

[4] The $5,057.98 amount was arrived at in the following manner:

Fair rental value ($560 x 12)	$6,720.00	
Utilities	1,178.52	
Repairs and replacement	411.46	
		$8,309.98
Less Government assistance ($271 x 12)		3,252.00
		$5,057.98

	Erin	Devin
Residence	$1,011.60	$1,011.60
Food	587.00	495.55
Clothing	418.48	435.57
Automobile[5]	455.11	455.11
Medical	84.09	57.91
Haircuts	60.00	64.00
Child care	758.40	1,087.60
Entertainment	152.00	152.00
Gifts		27.88
Miscellaneous	85.94	89.86
	$3,612.62	$3,877.08
Less John's support payments	2,075.00	2,075.00
Total support furnished by Anna	$1,537.62	$1,802.08

The total support furnished to the children during 1981 was as follows:

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[5] Our finding of the amount of this item of support reflects Anna's requested finding on brief, except that we have excluded the amount allocable to Anna's work-related travel (62.5 percent) and therefore considered only the amount properly allocable to non-work related travel (37.5 percent).

	Erin	Devin
John	$2,570.88	$2,513.58
Anna	1,537.62	1,802.08
Government assistance[6]	650.40	650.40
Total[7]	$4,758.90	$4,966.06

For the taxable year ended December 31, 1981, both John and Anna claimed dependency deductions for their two children. In his statutory notices of deficiency, both dated February 15, 1984, respondent disallowed both of their claimed deductions.

ULTIMATE FINDING OF FACT

More than one-half of the amounts expended for the support of the two children during 1981 was furnished by John.

OPINION

We must determine whether John or Anna is entitled to the dependency deduction claimed for their two children. It is always regretable that cases such as this come to trial. Section 151(e)[8] provides for a dependency exemption for each dependent as defined in section 152. Section 152(a) defines the term "dependent" as including, inter alia, a son or daughter of the taxpayer over half of whose support[9] for the calendar year was received from the taxpayer. Generally, the taxpayer has the burden of proving the amount he or she contributed toward the support of the children and that the amount exceeded one-half of their total support. Vance v. Commissioner, 36 T.C. 547, 549 (1961). However, section 152(e) provides, in part, that in the case of divorced parents a noncustodial parent is entitled to the dependency exemption if he or she provided at least $1,200 during the calendar year toward each child's support, unless the custodial parent can "clearly establish" that he or she provided more support for the child during that year than did the noncustodial parent. Sec. 152(e)(2)(B).

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[6] The amount of governmental assistance provided to each child was calculated as follows:

yearly housing support provided by the government x percentage allocation

($271 x 12) x 20% = $650.40

[7] Neither Erin nor Devin provided any amount towards their own support.

[8] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable year in issue.

There is no dispute that John made payments during 1981 of over $1,200 toward each child's support. Thus, Anna must "clearly establish" that she provided more support for each child. In order to "clearly establish" her support, she must show, by a clear preponderance of the evidence, that she provided more support than the noncustodial parent. Labay v. Commissioner, 55 T.C. 6, 13 (1970), affd. per curiam 450 F.2d 280 (5th Cir. 1971).

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[9] Support includes expenditures for food, shelter (including utilities and repairs), clothing, medical, education, allowances, toys, church contributions and the like. Sec. 1.152-1(a)(2)(i), Income Tax Regs.; Svendsen v. Commissioner, T.C. Memo. 1978-503. Generally, the amount of the expenditure is its cost. Sec. 1.152-1(a)(2)(i), Income Tax Regs. However, the amount of shelter furnished as an item of support is measured by its fair rental value. Blarek v. Commissioner, 23 T.C. 1037, 1039 (1955).

Anna maintains that she provided over half of the children's total support. In specific, she contends that the allocation of the housing costs should be pro rata and that the governmental assistance with respect to the mortgage interest payments does not constitute an item of support provided by a third party. We note that, even if the governmental assistance were not an item of support provided by a third party,[10] Anna still would not have provided over half of the children's support because of the 20-percent allocation per child of the housing costs. Thus, the critical argument that must be addressed is Anna's contention that the allocation of the housing costs should be pro rata and not 60 percent to herself and 20 percent to each child.

The house that Anna and the children resided in during 1981 had three bedrooms, one bathroom, a basement, a small living room, a combined kitchen and dining area, and a one-car garage. Anna testified that two of the three bedrooms were used by the children. She also testified that a portion of the basement was used as a playroom for the children to keep them out of the living room and that the other portion of the basement was utilized as a laundry room. Anna contends that this testimony clearly establishes that the housing costs should be allocated on a pro rata basis.

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[10] Contrary to Anna's contention, public assistance payments made by a governmental agency with respect to the mortgage on a taxpayer's residence constitutes support provided by the agency and not the taxpayer. Leggett v. Commissioner, T.C. Memo. 1976-7.

We do not agree with Anna's contention as the evidence does not clearly establish that a pro rata allocation is warranted. While the children did have their own bedrooms and the use of a portion of the basement, the record is unclear with respect to the use, if any, they had of the living room and garage area. In fact, one could infer from Anna's testimony that the children did not have any use of the living room since her reason for using a portion of the basement as a playroom was to keep the children out of the living room. Anna's contention also fails to take into account the fact that an adult has certain minimum base housing costs which are not equal to the minimum housing costs of minor children. On the record before us, we find that a more realistic allocation would be to credit Anna with 60 percent and each of the children with 20 percent of the housing costs.[11]

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[11] There are other cases in which we did not use a pro rata allocation. See McKay v. Commissioner, 34 T.C. 1080 (1960); Svendsen v. Commissioner, T.C. Memo. 1978-503; Tharp v. Commissioner, T.C. Memo. 1977-36; Cameron v. Commissioner, T.C. Memo. 1974-166.

It should be mentioned that, since the allocation of the housing costs is dispositive in the instant case, we accepted Anna's testimony that the fair rental value of her residence was $560 per month. We note, however, that her estimate was not supported in the record by any independent appraisals. Thus, were a determination of the fair rental value crucial to the outcome of this case, we seriously doubt that we would find its value to be $560 per month since that amount was not clearly established by Anna.

Under this allocation, John provided over one-half of Erin's and Devin's support during the taxable year in issue.[12] To reflect the foregoing,

Decision will be entered for petitioner in docket No. 12940-84 and decision will be entered for respondent in docket No. 14596-84.

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[12] Having found for John, we need not address his contentions with respect to certain items of support furnished by Anna. Such contentions include, but are not limited to, the proper amount of automobile expense. Likewise, while we discussed in footnote 3 the airplane fare incurred by John, we find it unnecessary to address the other items that were not deemed support furnished by him to his children.

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T. C. Memo. 1986-333

MF 204

UNITED STATES TAX COURT

JOHN L. CONNELL and KETNA S. CONNELL, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13240-82. Filed July 31, 1986.

E. Gary Work, Jr., for the petitioners.

Francis C. Mucciolo, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: In a notice of deficiency dated March 16, 1982, respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	Deficiency
1975	$ 26,724
1976	5,164

ORIGINAL

G.M

In an amendment to his answer filed with the Court on June 21, 1983, respondent claimed an increased deficiency for 1976 in the amount of $16,167.

The issues for decision are:

(1) Whether, for purposes of section 170,[1] petitioner John L. Connell made a bargain sale to the State of Florida in 1975 of his one-half interest in 211.341 acres and his one-half interest in an option on 217.659 acres, and, if so, the amount of the bargain.

(2) Whether petitioner John L. Connell properly valued his one-half interest in 5.605 acres transferred to the State of Florida in 1975.

(3) Whether petitioner John L. Connell made a charitable contribution of his one-half interest in an 11.28 acre right-of-way transferred to Alachua County, Florida, in 1976, and, if so, the amount of the contribution.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

John L. Connell (hereinafter petitioner) resided in Micanopy, Florida, when the petition was filed in this case. Petitioner Ketna S. Connell resided in Gainesville, Florida, at that time. Petitioners filed joint Federal income tax returns for the years 1975 and 1976 with the Internal Revenue Service Center at Chamblee, Georgia.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

On December 22, 1971, John D. Deen entered into a contract to purchase certain real property and to acquire an option on other real property from Lovette and Dorothy M. Jackson. On the survey plat prepared by M. K. Flowers and Associates, the property contracted for sale to Deen consisted of parcels 1C, 1D, 2, 3, and 133.054 acres north of parcel 2 and the optioned property consisted of parcel 1A and 31.245 acres just south of parcel 1A. This contract was later modified to extend the closing date and to authorize the Jacksons to sell certain of the optioned lands to the City of Gainesville in exchange for granting Deen an option to purchase additional property, including parcel 1B.

On April 28, 1973, petitioner and Billy A. Myrick, a long-time business associate of petitioner, entered into an agreement with Deen for an assignment of all of Deen's contract and option rights with the Jacksons for $500,000. Approximately $378,380 of the $500,000 paid to Deen was allocated to the contract rights, with the balance of $121,620 being allocated to the option rights. On July 16, 1973, petitioner and Myrick transferred an option to John G. Powell and Norman L. DeMeza on property known as "The Sweetwater Tract." The Sweetwater Tract included all of the property covered by the contract and option acquired from

Deen. Powell and DeMeza paid $10,000 for a 30-day option to purchase the tract. This option covered a total of 550.5 acres and set a closing price of $2,202,000, or $4,000 per acre. Powell and DeMeza purchased the option with the intention of reselling the property to a developer. They allowed the option to lapse, however, because they were unable to locate a developer interested in purchasing the property.

On February 15, 1974, petitioner and Myrick closed with the Jacksons on parcels 2 (211.341 acres) and 3 (5.605 acres) and a parcel north of parcel 2 (133.054 acres), a total of 350 acres. The total price paid by petitioner and Myrick for the 350 acres was $1,078,380 or $3,081 per acre, which included the allocable portion of the payment made to Deen. After the closing, petitioner and Myrick continued to hold option rights on parcels 1A, 1B, 1C, and 1D,[2] a total of 217.659 acres.

As early as February 1, 1974, petitioner and Myrick were communicating with the State of Florida to determine whether the State was interested in purchasing any of the Jackson property. In early 1974, the State sent Charlie Smith, a purchasing agent, to examine the property. The State's interest in the property stemmed from the fact that it was adjacent to the area known as

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[2] The parties stipulated that parcels IC and ID were part of the property which Deen contracted to purchase from the Jacksons. They also stipulated, however, that the disposition by petitioner and Myrick consisted of option rights on parcels IC and ID. We are unable from the record to determine the mechanism by which petitioner and Myrick acquired an option on the two parcels, but we will accept this fact as agreed to by the parties.

Payne's Prairie State Preserve and would serve as a buffer between the prairie and development along the edge of Gainesville.

At the request of the State of Florida, an appraisal of the properties owned by and under option to petitioner and Myrick was made by Harry B. Broom, Jr., M.A.I.[3] This appraisal was first completed on November 27, 1974, and purported to cover 539.32 acres. Broom valued the property at $2,427,000 or $4,275 per acre. A later survey showed that the land covered by the appraisal actually consisted of 567.659 acres. After receiving this appraisal the State notified Broom that it was only interested in purchasing parcels 1A, 1B, 1C, 1D, and 2, a total of 429 acres. On December 17, 1974, Broom issued a letter valuing the 429 acres by first valuing the 110.32 acres the State did not wish to purchase and subtracting this amount from the original valuation of the entire tract. Broom valued the 429 acres at $2,041,000 or $4,758 per acre. After issuance of this letter, Broom was notified by Alfred F. Tolius, Staff Appraiser for the State of Florida, Department of Natural Resources, that the State wanted the 429 acres valued separately without consideration of the remainder of the tract. On January 20,

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[3] This designation indicates membership in the American Institute of Real Estate Appraisers.

1975, Broom issued a second letter valuing the 429 acres separately. In this letter Broom determined the value of the property to be $1,656,000 or $3,860 per acre.

The land acquisition was negotiated by the Division of Recreation and Parks of the Florida Department of Natural Resources. The Governor and the State Cabinet, however, had to approve the acquisition. The State did not require petitioner and Myrick to keep the property off the market during the negotiations, which continued for approximately 13 months, but petitioner and Myrick did not attempt to sell the property during this time. In hopes of accelerating the State's land acquisition process petitioner and Myrick hired Randolph Hodges, a former executive of the Department of Natural Resources, to assist in dealing with the State officials. Petitioner and Myrick also hired Harold Haimowitz, an attorney, as a lobbyist to the Florida State Cabinet.

Following negotiations with petitioner and Myrick, the Department of Natural Resources recommended a purchase price of $1,501,500 or $3,500 per acre. The Department's recommended purchase price was considered by the Governor and Cabinet during a meeting on March 3, 1975. Petitioner and Myrick were present at this meeting and were able to speak before the State officials in attendance. After discussion of the purchase, the Governor and Cabinet voted to authorize the purchase of the 429 acres for $1,418,000 or $3,305 per acre. Petitioner and Myrick indicated during the meeting that they were willing to sell the property for this price. The appraised value of $1,656,000 and recommended purchase price of $1,501,500 were discussed at length during the meeting but at no time during the meeting did anyone suggest that the difference between either of these amounts and the authorized purchase price of $1,418,000 was to be a gift to the State.

On March 17, 1975, petitioner and Myrick transferred their interest in the 429 acres to the State of Florida. Of the 429 acres, 211.341 acres were transferred by warranty deed. Petitioner and Myrick assigned to the State their rights in the other 217.659 acres still under option with the Jacksons. The total consideration paid by the State to petitioner and Myrick for the fee simple transfer and the option was $1,204,538. The State paid $213,462 to the Jacksons to close on the optioned 217.659 acres. The total consideration paid by the State was $1,418,000.[4]

In 1975, petitioner and Myrick also transferred parcel 3 (5.605 acres) to the State. This parcel was transferred to provide road frontage for the 429 acres and, because it was the high point of the property, to provide a view over the prairie. The purchase agreement for the 429 acres did not require petitioner and Myrick to convey the 5.605 acres to the State. Petitioner and Myrick had, however, notified the State of their intention to donate the 5.605 acres prior to the State's purchase of the 429 acres. The 5.605 acres were included in Broom's original appraisal but were not valued separately. Broom's amendments to his appraisal did not include this parcel. On April 22, 1975, Charlie Smith of the Department of Natural Resources sent petitioner and Myrick a letter concerning their transfers of property to the State. The letter thanked petitioner and Myrick for their donation of property to the State. The letter valued the gift at $288,000, based on the difference between an appraised value for the properties of $1,706,000 and a net cost to the State of $1,418,000. The $1,706,000 appraised value stated in the letter was not taken from Broom's appraisal and its source has not been identified.

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[4] Petitioner and Myrick had dealt with the State as if they owned the 429 acres in fee simple. In fact, they never exercised the option on the 217.659 acres and, therefore, the closing price on the option was deducted from the price paid to petitioner and Myrick by the State.

After the sale of the 429 acres and the transfer of the 5.605 acres, petitioner and Myrick retained 133.054 acres of the property acquired from the Jacksons. On October 26, 1976, petitioner filed a zoning application with Alachua County requesting that this property be rezoned from AG (agricultural) to PUD (planned unit development). Prior to applying for the rezoning, petitioner was aware of the fact that the building of a highway across this property was part of the Alachua County thoroughfare plan. The proposed highway was to be part of a loop road around Gainesville. In putting together a plan of proposed development, petitioner and Myrick hired a surveyor, Robert Wigglesworth, to work with themselves and a county engineer, Charles Morgan, on placement of a right-of-way for the highway. The county thoroughfare plan allowed for flexibility as to the placement of the right-of-way. Restrictions on the placement of the right-of-way included the location of the intersection of 16th Avenue and State Road 331 and constraints based upon good engineering for the speed and design of the proposed highway. The plan of proposed development was submitted with the application for rezoning and showed the proposed right-of-way.

After receiving the rezoning application, the county made a request for a dedication of a right-of-way. Whenever a zoning change was proposed to allow for the subsequent development of property and the development would affect one of the proposed thoroughfares, the county engineer reported to the Board of County Commissioners on the nature of the proposed road passing through the property. As standard procedure, the board would then request that the property owner dedicate a right-of-way to the county.

Funding to build the highway through petitioner and Myrick's land was not in the county budget and the county could not require the dedication of a right-of-way as a condition to granting the request for rezoning. If petitioner and Myrick had refused to dedicate the right-of-way the county's only recourse would have been to require that an alignment of the right-of-way be established and that any proposed improvements be set back from the alignment. The county would then have had to purchase or condemn the right-of-way in order to build the proposed thoroughfare. Construction of the thoroughfare, however, was not part of the county's 5-year road building plan.

On December 21, 1976, the Board of Alachua County Commissioners approved, subject to certain stipulations, petitioner's request to rezone the property. The stipulations upon which approval was conditioned provided that no access be permitted directly from State Road 331 to any of the proposed uses and that approval did not commit Alachua County to construct the proposed 16th Avenue extension through the property. The stipulations did not require petitioner and Myrick to dedicate the right-of-way as a condition to approval of the rezoning. On December 28, 1976, petitioner and Myrick transferred 11.28 acres of the property to Alachua County.

On his Federal income tax return for the year 1975 petitioner claimed a charitable contribution deduction for a donation of property to the State of Florida. Petitioner determined the amount of his donation to be $144,000. This amount is one-half of the difference between the value of the property sold to the State as determined by Broom's appraisal and the amount paid by the State, plus $25,000, one-half of the claimed value of the 5.605 acres contributed to the State.

On his Federal income tax return for the year 1976 petitioner claimed a charitable contribution deduction for a donation of property to Alachua County. Petitioner determined the amount of the donation to be $67,200,[5] one-half of the alleged value of the 11.28 acres dedicated to the county.

OPINION

1. Sale of Interest in 211.341 Acres and Option on 217.659 Acres

The first issue for decision is whether petitioner's sale to the State of Florida of his one-half interest in 211.341 acres and his one-half interest in an option on 217.659 acres included a charitable bargain element, and if so, the amount of the bargain.

Section 170 generally provides a deduction for charitable contributions. Section 170(c)(1) provides, inter alia, that a State or a political subdivision thereof is a qualified recipient of such a contribution if the contribution is made for exclusively public purposes. The parties agree that the State of Florida is an organization of the character described in section 170(c)(1) and that the property transferred was to be used for exclusively public purposes. Respondent contends, however, that this transaction was nothing more than an arm's-length sale and that it lacked any bargain element. He asserts that the fair market value of the property did not exceed the amount paid to petitioner and, furthermore, that the character of the negotiations demonstrates that the sale was made without donative intent.

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[5] This amount is based on a value of $12,000 per acre for the property and a dedication of 11.2 acres. The actual number of acres dedicated to the county was 11.28.

Conversely, petitioners contend that Broom's appraisal was accurate and was accepted by the State in arm's-length negotiations as the value of the property. They further contend that the difference between the appraised value determined in Broom's report and the amount the State paid for the property was intended to be a gift to the State. Petitioners argue that they have satisfied the requirements of section 170 and that the amount of the gift is, therefore, a deductible charitable contribution.

We agree with respondent that donative intent has not been established with respect to this transaction. "In order for a conveyance to constitute a charitable contribution as a bargain sale the seller must make the conveyance with the requisite charitable intent and the fair market value of the property on the date of the sale must in fact exceed the sales price." Grinslade v. Commissioner, 59 T.C. 566, 577 (1973). The burden of proof is on petitioners. Rule 142(a).[6] Petitioners must therefore demonstrate by a preponderance of the evidence (1) that they made the transfer to the State with donative intent, and (2) that the fair market value of the property did in fact exceed the amount paid by the State. In order to show donative intent it must be proven that any excess of the fair market value of the property over the amount paid by the State was surrendered to the State as a gift. Such a transfer is a gift only if it is made primarily for "the satisfaction which flows from the performance of a generous act * * *." DeJong v. Commissioner, 36 T.C. 896, 899 (1961), affd. 309 F.2d 373 (9th Cir. 1962).

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[6] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

Whether donative intent was present in petitioner's transfer depends upon whether his willingness to convey the property to the State for less than its alleged value was primarily motivated by charitable impulses. Because the final purchase price for the property was recommended, discussed and accepted at the meeting of the Governor and Cabinet on March 3, 1975, we look first to the transcript of that meeting to determine petitioner's intention. Mr. Turlington, a member of the Cabinet, initially recommended the purchase price of $1,418,000 for the 429 acres. A lengthy discussion followed Turlington's recommendation, during which both petitioner and Myrick stated that their reason for accepting the price recommended by Turlington was that negotiations had dragged on for 13 months and they wanted to close the deal so that they could get on with their other business.[7] They requested that the Governor and Cabinet act on

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[7] Part of the discussion in response to Turlington's recommendation was as follows:

GOVERNOR ASKEW: What is your reaction to the reduced price? I
(footnote continued)

Turlington's motion and they agreed to accept the price recommended by Turlington. Th[illegible]lso requested that the motion not require the transfer of the 5.605 acres because they wished to treat its transfer as a donation for Federal tax purposes. At no time, however, did they attribute their willingness to

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(footnote continued from previous page)
personally would like to see us buy this, I'm not, I don't feel like that of the area that the Department of Natural Resources is recommending as buffers all around Payne Prairie, I'm not sure that that would be of sufficient priority in consideration of the limitation that, of funds that we have. But, this one area I think probably is the most critical of any possible areas surrounding that. And, my question really becomes one not so much of our desire not to buy it but a desire to try and reconcile the purchase price.

MR. CONNELL: Well, Governor, all I would say about that is put yourself in our place who have negotiated all this period of time in good faith. I never saw the state's appraiser before he walked on that piece of property. We didn't dictate which piece of property we would or would not sell. We gave the state the prerogative of determining it themselves. And all that I would ask is that you gentlemen as fair Commissioners and fair to both sides, make that decision.

MR. SHEVIN: Sir, about 5.6 acres, would you consider donating that, recognizing that you would a get a substantial federal tax break as a result of such a donation?

MR. CONNELL: We, as I said before, Mr. Shevin, we intended to give that to the State of Florida and Alachua County because we want them to have it. Now, like you gentlemen, I was a public servant for some 8 years. I know that the people of Alachua County and the State of Florida can use that piece of property. I wasn't at all sold on going this route when I first got started in this route, it was the idea of keeping the state off my back when I started to developing it. And, so that's not the way it was because you had a genuine interest in it. And, we have gone this route. Now if you really can conscientiously say that after 13 months and we've paid over $100,000 in interest by working with you all, that you should cut it down another $100,000 . . . .

MR. O'MALLEY: $155,000.

(footnote continued)

transfer the 429 acres for less than appraised value to charitable benevolence. Their stated desire to separate the donative transfer of the 5.605 acres from the sale of the 429 acres in combination with their failure to express a donative

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(footnote continued from previous page)

MR. CONNELL: . . . or whatever you're talking about. We've already cut it a $150,000 below your appraisal, then I wouldn't sit here and tell you we wouldn't negotiate. But, I am saying that I think it is only fair that you accept the reports and the appraisals and act upon them and act in our favor under these circumstances.

* * *

MR. CONNELL: Governor and gentlemen. Mr. Myrick and myself, no question believe, there's no question but what we do believe the matter before you should be acted on affirmatively at the prices that have been quoted. Now, it is also true though that it has cost us over $100,000 in interest alone. And, the long 13 months that we have been acting in good faith, there's no question about that. The point that I'm trying to make is that Mr. Myrick and myself are both businessmen, we have been up here many times to these various hearings. And, before letting this thing drag on and on and on, after talking to Mr. Myrick, we would like to close it out at Mr. Turlington's suggestion and get on with the business at hand.

GOVERNOR ASKEW: Well, that's the original motion. We have a substitute to renegotiate.

MR. CONNELL: Well, I understand that that's why I'm speaking now to the matter because this is $250,000 below. If it will save us constantly going through this thing and very frankly we both have just, you know, you haven't been on the other side of the position, I guess. But, we'd like to clear the matter up today. We'd like to have Mr. Turlington's motion acted. We do intend, to give the other piece of property. We'd rather not have it tied to the motion, so that it will be for tax purposes. But, we would like to complete it and get on with our business.

MR. SHEVIN: I'll withdraw my motion.

MR. CONNELL: Thank you.

MR. O'MALLEY: I don't know whether or not I want to withdraw my second?

(footnote continued)

intent with respect to any portion of the 429 acres strongly suggests that they did not view the sale as including a partial gift to the State.

Petitioners assert that the Department of Natural Resources had negotiated for a partial gift of the property prior to the meeting of the Governor and Cabinet on March 3, 1975. The Department of Natural Resources, however, had not negotiated the price of $1,418,000. That price was proposed and accepted at the meeting of the Governor and Cabinet. The price negotiated by the Department was $1,501,500 or $3,500 per acre. At trial petitioner testified that he and Myrick were willing to sell the property for less than the $3,860 per acre appraised value determined by Broom only on the conditions that the State accept the appraised value as the value of the property and that the

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(footnote continued from previous page)

GOVERNOR ASKEW: I beg your pardon, Sir?

MR. MYRICK: May I say something, Sir?

GOVERNOR ASKEW: Yes, Sir.

MR. MYRICK: The only thing that I do want to say by my partner, John and I discussing this, was the original price the $1,501,500, at that point was what we told the chief negotiator in the Department of Natural Resources was the least price we would take. We based that on the fact that the land had been under contract well twice in fact, from $4000 to $6000 an acre for sale. And, so at any point, at any rate we stopped at that point. My reason now for accepting Commissioner Turlington's offer here is just as John pointed out there, we feel that we've come this far and we would like to get on with our other business about what we're going to do with the rest of the property. And, we would appreciate if it you would act on that situation.

difference would constitute a charitable contribution. Acceptance of the $3,500 per acre price by petitioner and Myrick, however, was confirmed in a letter from Myrick to Smith dated October 10, 1974, more than 2 months before Broom's first appraisal of the 429 acres. The letter stated:

> This is to confirm our discussion earlier this week concerning the referenced parcel of land. As we discussed, our price is $3500.00 per acre for the 400 to 450 acre parcel and we will reduce this to $3200.00 per acre should the State desire the entire 568+ acre tract.

Again, there is no indication that petitioner and Myrick were contemplating a gift to the State of part of the property. Because this letter was issued prior to Broom's appraisal it contradicts petitioner's statement at trial that he and Myrick were unwilling to accept less than the appraised value determined by Broom unless their conditions were met.

There is no evidence in the record that any party had proposed a partial gift prior to October 10, 1974, the date on which petitioner and Myrick confirmed their acceptance of the price of $3,500 per acre for the 429 acres. At trial petitioner testified that Smith was the first to propose a partial gift to the State and that Smith had Broom's appraisal before he made this proposal. Broom's final appraisal of the 429 acres, however, followed petitioner and Myrick's acceptance of the $3,500 per acre price by approximately 3 months. This would seem to be an admission by petitioner that a gift was not being contemplated when the price of $3,500 per acre was accepted. The evidence in this case does not establish that in accepting the price of $3,500 per acre petitioner's motivation was charitable. Likewise, there is no evidence that petitioner and Myrick knew that the price of $3,305 per acre would be proposed at the meeting of the Governor and Cabinet on March 3, 1975. They accepted this price during the meeting without indicating in any way that they were accepting a price below market value with the intention of making a gift to the State.

Petitioners nonetheless assert that the letter dated April 22, 1975 from Smith to petitioner and Myrick proves their donative intent. This letter stated:

> The Department of Natural Resources, Division of Recreation and Parks would like to express its appreciation for the $288,000 donation, including the separate deed for 5.6 acres of road frontage to be used as an entrance station. This property being acquired will be used for limited recreation in Paynes Prairie State Preserve for the use and benefit of all the citizens of Florida and its visitors.
>
> Taking into consideration the firm price based on the appraisal of $1,706,000, copy attached, and the net cost to the State of $1,418,000 constitutes a donation of $288,000 and the value of the gift is $288,000. This $288,000 donation represents a very generous gesture on the part of you gentlemen, and we wish to again express our very sincere appreciation for this magnanimous act.

The $1,706,000 figure is apparently the sum of Broom's appraised value for the 429 acres and an alleged $50,000 value for the 5.605 acres. We find this letter insufficient to establish that petitioner was motivated by charitable benevolence to accept the final price offered by the State. Alfred Tolius, an appraiser for the Department of Natural Resources in 1974 and

1975, testified that in the latter stages of the transaction "around the time of closing, there was some discussion of a gift." The closing occurred on March 17, 1975. Clearly, any discussion of a gift after October 10, 1974 does not establish that the price of $3,500 per acre was accepted with donative intent unless it is found to reflect discussions prior to such date. Similarly, discussion of a gift after the meeting of the Governor and Cabinet on March 3, 1975, does not establish that the price of $3,305 per acre was accepted with donative intent unless found to reflect discussions during or prior to such meeting. We do not find that Smith's letter reflects the intent of petitioner at the time he accepted the purchase price offered by the State.

Petitioner has failed to show that he made the transfer to the State with the requisite donative intent. Accordingly, we hold that petitioners are not entitled to a deduction for a bargain sale to the State of Florida in 1975 of their interest in the 429 acres.

2. Donation of 5.605 Acres to State

We next consider whether petitioner properly valued his one-half interest in 5.605 acres transferred to the State of Florida in 1975.

Petitioner contends that the fair market value of the parcel at the time of transfer was $50,000. Respondent contends that the fair market value was not in excess of $35,000. Respondent has not disputed that the fair market value of the parcel is deductible as a charitable contribution.

In general, the amount of a charitable contribution made in property other than money is the fair market value of the property at the time of contribution. Sec. 1.170A-1(c)(1), Income Tax Regs. "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs.; McGuire v. Commissioner, 44 T.C. 801, 806 (1965). As we have stated previously, however, valuation of property "should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement." Messing v. Commissioner, 48 T.C. 502, 512 (1967).

To establish a valuation for the 5.605 acres, respondent relies on an appraisal of the parcel prepared by one of his appraisers, Richard Farmer, Jr. Respondent's appraiser used comparable sales to value the property. Among other adjustments made to the prices of the five comparable sales used, Farmer made downward adjustments to the prices of all the comparable sales because of a 150-foot transmission line easement over the 5.605

acres. Farmer also made downward adjustments to the prices because he believed that access from the road was less available to the 5.605 acres than to the comparables. Farmer's report stated that access to the property from State Road 331 was limited because of a concrete wall along the road and because of the steep incline from the road to the property. The parcel has 725 feet of frontage along State Road 331.

Petitioners rely solely on the April 22, 1975 letter from Smith to establish their valuation of the 5.605 acres. They object to Farmer's appraisal on numerous grounds. They argue that the transmission easement does not impair development because the easement can accomodate parking and other forms of development which would not interfere with the transmission lines. Petitioners assert that the wall along State Road 331 is not more than 3 feet high and that little engineering skill would be required to grade an entrance into the site at any point along the frontage. Petitioners object to the report's determination that the highest and best use of the property was as investment property rather than as development property. Petitioners also assert that Farmer's report understated the price of one of the 5 comparables by approximately $770 per acre.

Respondent concedes that Farmer's report did err by understating the price of one of the comparables by $770 per acre. In addition, we agree with petitioners that the wall between State Road 331 and the property would probably not constitute a significant hindrance to road access. The letter written by Smith, however, is of little use to us in determining the fair market value of the property. The basis for the value set forth in the letter has not been made clear to us. The letter refers to an attached appraisal but petitioners have failed to present to us an appraisal which values the 5.605 acres. We will therefore use $35,000 as the starting point for valuing the property but will increase this amount for the error in pricing the comparable and for the assumption as to limited road access. We deem an appropriate adjustment to be $800 per acre. Rounding the result, we conclude that the fair market value of the 5.605 acres was $40,000 at the time petitioner and Myrick transferred the parcel to the State.

3. Transfer of 11.28 Acre Right-of-Way

The final issue for decision is whether petitioner made a charitable contribution of his one-half interest in an 11.28 acre right-of-way transferred to Alachua County, Florida in 1976, and if so, the amount of his contribution.

Respondent contends that petitioner did not intend to make a gift when he transferred the right-of-way to Alachua County because the transfer was made with the expectation of receiving direct economic benefits. Respondent contends that petitioner expected and received favorable zoning of his land and public road access or frontage for some of his property. Respondent also contends that by dedicating the right-of-way petitioner ensured a favorable alignment of the right-of-way. Alternatively, respondent argues that transfer of the right-of-way increased the value of the parent tract and that the difference between the value of the parent tract before the transfer and the value of the remainder after the transfer exceeded the value of the right-of-way. Respondent contends that because the petitioner made a net profit from the transfer he should be denied a charitable contribution deduction. Respondent also asserts that if petitioner is entitled to a charitable contribution deduction, the amount of the deduction does not exceed $50,000.

Petitioner contends that any benefits which accrued to him at the time of the dedication of the right-of-way would have accrued whether or not he had made the dedication. Further, petitioner contends that had he not dedicated the right-of-way the county eventually would have had to condemn the property. Petitioner alleges that under Florida law enhancement of the value of the remaining property could not be considered in determining the amount the county would have had to pay for the property in condemnation proceedings and that this condemnation price should be the measure of the gift to the county. Petitioners also allege that the value of the right-of-way was $12,000 per acre.

The issues relating to whether a gift of the right-of-way was made by petitioner and whether an increase in the value of the remaining tract should be applied as an off-set to the amount of any gift were first raised by respondent in an amendment to his answer. These issues clearly constitute new matters and respondent bears the burden of proof on these issues. Rule 142(a); Achiro v. Commissioner, 77 T.C. 881, 890 (1981).[8] The value of the right-of-way, however, was challenged by respondent in the notice of deficiency. Therefore, petitioner bears the burden of proof as to this issue. Rule 142(a).

In dealing with the donative intent of a taxpayer, we stated in Sutton v. Commissioner, 57 T.C. 239, 243 (1971), that:

> Determining a taxpayer's incentive, motive, or purpose in making a gift is a factual problem. The inquiry, however, does more than probe the subjective attitude of the donor and the extent to which public-spirited and charitable benevolence prompted the transfer. The inquiry seeks to expose the true nature of the transaction: whether the "gift" was made "in expectation of the receipt of certain specific direct economic benefits within the power of the recipient to bestow directly or indirectly, which otherwise might not be forthcoming." Stubbs v. United States, 428 F.2d 885, 887 (C.A. 9, 1970).

For us to find that petitioner's dedication of the right-of-way was not a gift for purposes of section 170, respondent must prove that petitioner made the dedication expecting to receive economic benefits which he might not otherwise receive. Respondent has asserted that petitioner made the dedication in expectation of receiving three such benefits: (1) public road access or frontage for some of his property; (2) favorable zoning of the remainder of his land; and, (3) a favorable alignment of the right-of-way.

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[8] See also Seldin v. Commissioner, T.C. Memo. 1969-233.

We note that respondent has offered no evidence which suggests that petitioner's dedication of the right-of-way increased the likelihood of the loop road being built through petitioner's property. The county thoroughfare plan, of which the loop road was a part, merely designated roads which might be needed sometime in the future. The loop road was not included in the county's 5-year road building plan. Also, the loop road was planned as a highway, not as an access road to petitioner's property, and therefore, the development of petitioner's property would not necessarily affect the likelihood of the road being built. For these reasons we do not believe that petitioner dedicated the right-of-way to gain public road access or frontage for some of his property.

Respondent has not disputed that under Florida law Alachua County could not have required petitioner to dedicate a right-of-way to the county as a condition to granting the rezoning request. Nor does respondent directly claim that Alachua County officials unlawfully required that petitioner make such a dedication. Respondent does contend that petitioner viewed the dedication as being in exchange for the rezoning. Respondent apparently draws this conclusion from the fact that the zoning application showed a proposed right-of-way which was dedicated 1 week after the rezoning was approved. Without more evidence than respondent has put before us, however, we will not find that county officials would act unlawfully to require the dedication or that petitioner would expect them to so act. Due to respondent's having failed to satisfy his burden of proof, we must assume that petitioner's rezoning request would have been granted without the dedication of the right-of-way and that petitioner would not have expected the dedication to determine whether the rezoning request was approved.

Respondent contends that petitioner expected a favorable alignment of the right-of-way in exchange for making the dedication. Robert Wigglesworth, the surveyor hired by petitioner and Myrick to aid in placing the right-of-way, testified at trial that the placement had to satisfy the county's needs and the desire of petitioner and Myrick that the rest of the property not be hindered by the right-of-way. Had petitioner and Myrick not dedicated the right-of-way, the county would have required that an alignment be established and that all development be set back from this alignment. If the alignment sought by petitioner and Myrick upon agreeing to dedicate the right-of-way satisfied the county's needs, we see no basis upon which the county would have rejected this alignment had petitioner and Myrick not chosen to make the dedication. Respondent has failed to offer evidence to the contrary.

In the cases cited by respondent, the courts found that each conveyance in question was not a gift because it was made by the donor in expectation of receiving specific direct economic benefits. See Stubbs v. Commissioner, 428 F.2d 885 (9th Cir. 1970), cert. denied 400 U.S. 1009 (1971); Pettit v. Commissioner, 61 T.C. 634 (1974); Sutton v. Commissioner, supra. Respondent has failed to demonstrate that petitioner made the dedication in expectation of receiving such economic benefits. Accordingly, we hold that petitioner's dedication of the right-of-way did constitute a gift to Alachua County for purposes of section 170.

Respondent contends that, if we find that petitioner made a gift, the net amount of the gift should nonetheless be zero. He argues that the value of the parent tract prior to the dedication was $570,000, the value of the remaining property after the dedication was $635,000, and that the value of the dedicated right-of-way was $50,000. Respondent concludes that petitioner received a net benefit of $15,000 ($635,000 - 570,000 - 50,000), and should therefore be denied a charitable deduction. Without considering whether respondent's values are accurate, we think his analysis is wrong in this case.

"It is well established that payments to an organization which qualifies as a charity are deductible as a charitable contribution under section 170 only to the extent the amount thereof exceeds the fair market value of any material benefit received in return." Murphy v. Commissioner, 54 T.C. 249, 253 received in return." Murphy v. Commissioner, 54 T.C. 249, 253 (1970). Respondent has the burden of proving that petitioner received a material benefit "in return" for the dedication and the fair market value of such benefit. Rule 142(a). Respondent argues on brief that the increase in the value of petitioner's remaining property resulted from the dedication of the right-of-way. Farmer's appraisal, upon which respondent bases his valuations of the property, however, states that the alleged increase in the value of the remainder tract was considered to have resulted from the "strategic location" of the right-of-way and the "upgrading in the remainder's zoning" from agricultural to planned unit development. We find that any increase in the value of the remainder tract resulted from the setting of the alignment of the right-of-way and the change in zoning, and not from the dedication of the right-of-way. As we have stated above, respondent has not shown that the county would have had reason to require a different alignment of the right-of-way had petitioner not dedicated the right-of-way. Nor has respondent demonstrated that the rezoning application would have been denied had petitioner failed to make the dedication. Thus, on this record, there is no indication that petitioner received a material benefit as a result of making the dedication.

Accordingly, we hold that the measure of petitioner's gift to Alachua County is the fair market value of the dedicated right-of-way.[9]

Respondent contends that the value of the dedicated right-of-way was $50,000 or approximately $4,500 per acre. Petitioner contends that the value was $12,000 per acre. Here again, we enter the realm of Solomon-style decision making. Respondent bases his valuation on an appraisal by Farmer. Petitioner has not identified the basis for his valuation but has made numerous objections to respondent's appraisal.

Respondent's appraiser valued the 11.28 acre right-of-way by using four comparable sales to estimate the per acre value of the entire 133 acre parent tract.[10] Farmer considered this a reasonable estimate of the per acre value of the 11.28 acres. The appraisal stated that the date of valuation was December 28, 1976, the date of conveyance. While this was a week after approval of the rezoning, Farmer valued the parent tract as if it were zoned AG and the alignment for the right-of-way had not been established. However, as part of this appraisal, Farmer also estimated the value of the remainder tract after the dedication. In this part of the appraisal he valued the property based on PUD zoning and the established alignment for the right-of-way. Farmer estimated a value of $5,500 per acre using the same four comparable sales but making different adjustments to their prices.

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[9] Cf. Scheffres v. Commissioner, T.C. Memo. 1969-41; Seldin v. Commissioner, T.C. Memo. 1969-233.

[10] Farmer's appraisal actually stated that the parent tract consisted of 127 acres. The parties have stipulated, however, that the 133.054 acreage determined by the surveyors M. K. Flowers and Associates was correct.

The four comparable sales used by Farmer consisted of: (1) a sale of property, the price of which was understated by $770 per acre; (2) a listing for nearby property; (3) the earlier sale of the 429 acres by petitioner and Myrick to the State of Florida; and, (4) a 1978 sale of the remainder tract by petitioner and Myrick for $6,200 per acre. Considering the questionable propriety of using some of these comparables and Farmer's failure to base his valuation upon the facts as they existed on the date of valuation, we think the appraisal is of doubtful worth in determining the value of the right-of-way. Unfortunately, it is the only basis we have been given for valuing the right-of-way. As such, we hold the per acre value of the right-of-way to be the same as the per acre value estimated by Farmer as the value of the remainder tract after the dedication. This estimate was $5,500 per acre, which we round out to a total value of $62,000.

Accordingly, we hold that petitioner is entitled to a charitable contribution deduction for the dedication to Alachua County of his one-half interest in the right-of-way based on a fair market value of $62,000 for the right-of-way.

Decision will be entered
under Rule 155.